Performance and Accountability Report

Fiscal Year 2004

Homeland Security

Appendix B – Independent Auditor's Report and Management's Response to the Independent Auditor's Report

Office of Inspector General

U.S. Department of Homeland Security
Washington, DC 20528

Homeland Security

November 19, 2004

MEMORANDUM FOR: The Honorable Tom Ridge, Secretary

FROM: for Richard L. Skinner Clark Kent Ervin, Inspector General

SUBJECT: *Independent Auditors' Report on DHS' FY 2004 Financial Statements*
Audit Report No. OIG-05-05

The attached report presents the results of the Department of Homeland Security's (the Department) financial statement audits for fiscal year (FY) 2004 and the seven months ended September 30, 2003. These audits were required by the *Accountability of Tax Dollars Act of 2002*. This report is incorporated into the Department's FY 2004 *Performance and Accountability Report*. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits.

The Department experienced a setback in its financial reporting this year. For 2003, KPMG issued a qualified opinion on the Department's balance sheet and statement of custodial activity, meaning that these statements were presented fairly in all material respects, except for matters identified in the 2003 audit report. KPMG was unable to issue an opinion on any of the Department's FY 2004 financial statements, and the number of material weaknesses increased from 7 to 10 this year. Although this was a disappointment, it was not entirely a surprise given the number of material weaknesses at the Department and the accelerated reporting deadline. The conditions at Immigration and Customs Enforcement (ICE) are the most critical and, as discussed below, need immediate attention. In addition, the Office of the Chief Financial Officer (OCFO) needs additional resources if it is going to provide reliable financial reporting and leadership and technical support to the bureaus.

We hope that the Department can address these weaknesses in a timely fashion. If so, this year's results will represent only a temporary setback. My office will do all it can to assist the Department in this effort.

Summary of Auditors' Report

KPMG was unable to provide an opinion as to whether the Department's FY 2004 statements were presented fairly in all material respects. This disclaimer of opinion was due specifically to the circumstances at ICE, the inability to complete audit procedures over certain costs and budgetary transactions at the Coast Guard, the lack of reconciliations for intra-governmental balances, and the accelerated reporting deadline of November 15 that prevented an extension of audit procedures.

ICE did not adequately maintain its accounting records during FY 2004 and was unable to provide support for certain transactions. ICE' financial reporting environment underwent significant change in FY 2004. Its legacy agency, the Immigration and Naturalization Service, and the former U.S. Customs Service, were reorganized into three new bureaus: ICE, Customs and Border Protection (CBP) and Citizenship and Immigration Services (CIS). ICE experienced significant budget difficulties during the year due at least in part to the late preparation of agreements to reimburse it for costs incurred on others' behalf. In FY 2004 ICE became the accounting services provider for several other Department components, as well as supporting its own and CIS' accounting needs. ICE also experienced significant staff turnover. As a result, ICE fell seriously behind in basic accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting. A void exists in the financial management infrastructure at ICE that likely will continue to jeopardize the integrity of DHS financial reporting until the fundamental issues of internal control, which includes human capital practices and oversight, have been addressed.

KPMG was unable to complete audit procedures over certain costs and budgetary transactions at the Coast Guard. The Coast Guard contributes significantly to many of the material weaknesses identified in the auditors' report, and the accelerated reporting deadline left insufficient time for the auditors to overcome the difficulties these weaknesses presented.

The Department had significant out-of-balance conditions with other federal entities that were not reconciled; therefore, it could not support certain balances on its own books. The most significant out-of-balance conditions existed at ICE. A lack of resources in the OCFO prevented the accountant responsible for intra-governmental reconciliations from researching and reconciling these differences in a timely manner during the year and at year-end.

The financial statement audit had to be completed three months earlier than it was last year due to the accelerated reporting deadline of November 15. The Department had little time to focus on correcting deficiencies from KPMG's last report before being subjected to another financial statement audit. To have a high likelihood of meeting an accelerated reporting deadline, the Department's internal controls needed to be much better. The Department entered this audit with seven material weaknesses and seven other reportable conditions related to financial reporting.

For 2003, KPMG issued a qualified opinion on the Department's balance sheet and statement of custodial activity, meaning that these statements were presented fairly in all material respects, except for matters identified in the audit report. The qualification on the balance sheet was related to lack of certain documentation for $2.9 billion in property, plant, and equipment (PP&E) at the Coast Guard; KPMG's inability to observe physical count procedures or otherwise verify the recorded balance of $497 million in operating materials and supplies (OM&S) at the Coast Guard; and lack of certain documentation related to $3.3 billion in retirement benefits at the Secret Service and $201 million in post-employment benefits at the Coast Guard. As described in the auditors' report, PP&E and OM&S remain material weaknesses at DHS, primarily due to conditions at the Coast Guard. The Secret Service corrected its documentation problem for its recorded retirement benefits.

Summary of Reports on Internal Control and Compliance with Laws and Regulations

The FY 2004 auditors' report discusses 10 material weaknesses, three other reportable conditions in internal control, and four instances of non-compliance with laws and regulations, as follows:

Material Weaknesses

A. Financial Management Structure
B. Financial Management and Oversight at Immigration and Customs Enforcement
C. Financial Reporting in the Office of the Chief Financial Officer and DHS Components
D. Financial Systems Functionality and Technology
E. Fund Balance with Treasury
F. Property, Plant, and Equipment
G. Operating Materials and Supplies, and Seized Property
H. Undelivered Orders, Accounts and Grants Payable, and Disbursements
I. Budgetary Accounting
J. Intra-governmental and Intra-departmental Balances

Other Reportable Conditions

K. Deferred Revenue on Immigration and Naturalization Applications
L. Environmental Liabilities
M. Custodial Activity Performed by Customs and Border Protection

Non-compliance with Laws and Regulations

N. *Federal Managers' Financial Integrity Act of 1982*
O. *Federal Information Security Management Act*
P. *Single Audit Act Amendments of 1996*, Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up*, as revised, and the *Robert T. Stafford Disaster Relief and Emergency Assistance Act*, as amended October 2000
Q. *Improper Payments Information Act of 2002*

The auditors' report provides extensive information on the conditions creating the 10 material weaknesses identified in FY 2004, explains their causes, and provides recommendations. The most critical material weaknesses are described in the auditors' comment A, *Financial Management Structure*, and comment B, *Financial Management and Oversight at Immigration and Customs Enforcement*. The Department must address the OCFO's serious need for additional personnel with the specialized financial reporting experience and general ledger skills needed to ensure accurate, reliable, and timely financial reporting and to provide leadership, coordination, and technical support to the bureaus. The Department will have a much more difficult time correcting its material weaknesses and other reportable conditions without the addition of technical resources at the OCFO.

The Department must address the void in ICE' financial management infrastructure immediately to restore confidence its financial reporting. The auditors identified weaknesses in controls that might have allowed ICE to become anti-deficient or prevented management from knowing whether ICE was anti-deficient. This condition is very serious for ICE and for the Department.

The 10 material weaknesses represent a net increase of three over last year. Five remain from last year; two are new; and three moved from reportable condition to material weakness this year. There are three reportable conditions: one remains from last year; one is new; and one is a consolidation of two reportable conditions from last year. The auditors' report provides a summary of the status of 2003 findings. The Department must reduce the number of these material weaknesses if it is to increase the likelihood of meeting the accelerated reporting deadlines.

The auditors also tested the Department's compliance with certain provisions of laws, regulations, contracts, and grant agreements materially relevant to its financial statements. KPMG identified four areas of non-compliance, as listed above. Two areas remain from last year; one is new; and one has been expanded.

KPMG is responsible for the attached auditor's report dated November 8, 2004 and the conclusions expressed in the report. We do not express opinions on the financial statements or internal control or conclusions on compliance with laws and regulations.

We request that a corrective action plan be provided to us within 90 days of the date of this letter. If you or your staff have questions, you may contact me, or a member of your staff may contact J. Richard Berman, Assistant Inspector General for Audits, at 202-254-4100.

Attachment

KPMG LLP
2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

Secretary and Inspector General
U.S. Department of Homeland Security:

We were engaged to audit the accompanying consolidated balance sheet of the U.S. Department of Homeland Security (DHS) as of September 30, 2004, and the related consolidated statements of net cost, changes in net position, financing, and custodial activity, and combined statement of budgetary resources (hereinafter referred to as "financial statements"), for the year then ended. We have audited the accompanying consolidated balance sheet of DHS as of September 30, 2003, and the related statement of custodial activity for the seven months then ended. In accordance with instructions received from the Office of Management and Budget (OMB), only the accompanying consolidated balance sheet and related statement of custodial activity are presented in comparative form with the prior period financial statements.

In connection with our fiscal year 2004 engagement, we were also engaged to consider DHS' internal control over financial reporting and to test DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these financial statements.

Summary

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the financial statements as of, and for the year ended, September 30, 2004. Regarding the 2003 financial statements presented herein, as discussed in our report on the financial statements, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence related to certain financial statement balances, the accompanying consolidated balance sheet and statement of custodial activity, present fairly, in all material respects, the financial position of DHS as of September 30, 2003 and the related custodial activity for the seven months then ended, in conformity with accounting principles generally accepted in the United States of America.

As further described in Note 1 of the consolidated financial statements, DHS was established by the *Homeland Security Act of 2002* on November 19, 2002, as an Executive Branch Department of the United States government, and began operations on March 1, 2003.

Our consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

<u>Reportable Conditions That Are Considered To Be Material Weaknesses</u>

A. Financial Management Structure
B. Financial Management and Oversight at Immigration and Customs Enforcement
C. Financial Reporting in the Office of Chief Financial Officer and DHS Components
D. Financial Systems Functionality and Technology
E. Fund Balance with Treasury
F. Property, Plant, and Equipment
G. Operating Materials and Supplies, and Seized Property

H. Undelivered Orders, Accounts and Grants Payable, and Disbursements
I. Budgetary Accounting
J. Intragovernmental and Intradepartmental Balances

Other Reportable Conditions
K. Deferred Revenue on Immigration and Naturalization Applications
L. Environmental Liabilities
M. Custodial Activity Performed by Customs and Border Protection

The results of our tests of compliance with certain provisions of the following laws, regulations, contracts, and grant agreements disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*:

- *Federal Managers' Financial Integrity Act of 1982 (FMFIA)*
- *Federal Information Security Management Act (Electronic Government Act of 2002)*
- *Single Audit Act Amendments of 1996,* laws and regulations supporting OMB Circular No. A-50, *Audit Follow-up*, as revised, and the *Robert T. Stafford Disaster Relief and Emergency Assistance Act,* as amended October 2000
- *Improper Payments Information Act of 2002*

As discussed in our report on the financial statements the scope of our work was not sufficient to express an opinion on the financial statements as of and for the year ended September 30, 2004, and accordingly, other internal control matters and other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion.

DHS was not subject to the requirements of the *Chief Financial Officers Act of 1990* (CFO Act) during fiscal year 2004 and, consequently, was not required to comply with the *Federal Financial Management Improvement Act of 1996* (FFMIA). Therefore, we are not reporting herein on DHS's compliance with FFMIA. However, our testwork disclosed deficiencies in financial management information systems, the application of federal accounting standards, and recording of financial transactions, related to FFMIA that are presented within our report on internal control over financial reporting.

The following sections discuss the reasons why we are unable to express an opinion on the accompanying DHS financial statements as of and for the year ended September 30, 2004; our report on the consolidated balance sheet and statement of custodial activity as of and for the seven months ended September 30, 2003; our consideration of DHS's internal control over financial reporting; our tests of DHS's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

Report on the Financial Statements

We were engaged to audit the accompanying consolidated balance sheet of the U.S. Department of Homeland Security (DHS) as of September 30, 2004, and the related consolidated statements of net cost, changes in net position, financing, and custodial activity, and combined statement of budgetary resources, for the year then ended.

Immigration and Customs Enforcement (ICE), a significant component of DHS, did not adequately maintain its accounting records during fiscal year 2004, particularly with respect to balances transferred in from legacy agencies, intradepartmental and intragovernmental agreements and transactions, suspense accounts, costs and budgetary transactions, thus requiring extensive reconciliation and adjustment of these and other accounts at

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year end, which ICE was unable to complete. Also, ICE management was unable to provide evidential matter or was not able to make knowledgeable representation of facts and circumstances, regarding certain transactions occurring in fiscal year 2004. DHS was unable to complete and review the accompanying financial statements, or reconcile its intragovernmental balances, prior to the completion of our procedures. In addition, we were unable to complete audit procedures over certain costs and budgetary transactions of the U.S. Coast Guard (Coast Guard) for the year ended September 30, 2004. For fiscal year 2004, OMB required that federal agencies submit audited financial statements by November 15, 2004. It was impracticable to extend the time period and procedures of our audit sufficiently to determine the extent to which the financial statements as of and for the year ended September 30, 2004, may have been affected by these conditions.

Because of the matters discussed in the previous paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying financial statements of DHS as of and for the year ended September 30, 2004.

Regarding the 2003 financial statements, we audited the consolidated balance sheet of DHS as of September 30, 2003, and the related consolidated statement of custodial activity for the seven months then ended. Further, we were engaged to audit the related consolidated statements of net cost, changes in net position, and financing, and the related combined statement of budgetary resources for the seven months ended September 30, 2003. In accordance with instructions received from the OMB, only the 2003 consolidated balance sheet and related statement of custodial activity are presented in comparative form with the fiscal year 2004 financial statements.

The Coast Guard, a component entity of DHS, was unable to provide sufficient documentation, prior to the completion of our audit procedures, to support the acquisition value and existence of property, plant, and equipment (PP&E), amounting to $2.9 billion that is included within the $9.1 billion net PP&E balance stated in the accompanying consolidated balance sheet as of September 30, 2003. We were unable to observe a sufficient number of the physical counts of operating materials and supplies (OM&S) conducted by the Coast Guard, and we were unable to satisfy ourselves by other means as to the fairness of the quantities used in the valuation of OM&S, that amounted to $497 million included within the $1.2 billion net OM&S, inventory, and stockpile balance stated in the accompanying consolidated balance sheet as of September 30, 2003. The U.S. Secret Service, another component of DHS, and the Coast Guard were unable to provide sufficient documentation, prior to the completion of our audit procedures, to support retirement and post-employment benefits amounting to $3.3 billion and $201 million, respectively, included within the $25.3 billion military and other retirement balance stated in the accompanying consolidated balance sheet as of September 30, 2003.

Statement of Federal Financial Accounting Standard No. 3, *Accounting for Inventory and Related Property*, requires financial statement note disclosure of an analysis of prohibited seized property, including weight or item counts on-hand at the beginning of the year, seizures and disposals during the period, and on-hand weight or item counts at the end of the year (see Note 9). Because we were not engaged as auditors until after March 1, 2003, we were not present to observe the physical count of the prohibited seized property in DHS' possession on March 1, 2003, and we were unable to satisfy ourselves through other audit procedures as to beginning inventory quantities or seizures and disposals that occurred during the seven month period ended September 30, 2003.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence related to certain PP&E, OM&S, and retirement and post-employment benefits, as discussed in the fifth paragraph of this section, the accompanying consolidated balance sheet and statement of custodial activity present fairly, in all material respects, the financial position of DHS as of September 30, 2003, and the related custodial activity for the seven months then ended, in conformity with accounting principles generally accepted in the United States of America. The scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the consolidated statements of net cost, changes in net position, and financing, and combined statement of budgetary resources for the seven months ended September 30, 2003.

In addition, because of the matters discussed in the sixth paragraph of this section, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying disclosure in Note 9 of the weight and/or item counts of prohibited seized property transferred to DHS from legacy agencies on March 1, 2003, and seizures and disposals that occurred during the seven months ended September 30, 2003.

As further described in Note 1 of the consolidated financial statements, DHS was established by the *Homeland Security Act of 2002* on November 19, 2002, as an Executive Branch Department of the United States government, and began operations on March 1, 2003.

The information in the Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), and Required Supplementary Information (RSI) sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We did not audit the MD&A, RSSI, and RSI and, accordingly, we express no opinion on it. Certain information presented in the RSSI and RSI is based on net cost and budgetary data from the consolidated statements of net cost and changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2004 and the seven months ended September 30, 2003, on which we have not expressed an opinion. Furthermore, pursuant to OMB instructions, in certain cases, DHS has presented annualized information in the MD&A and RSSI disclosures for the twelve months ended September 30, 2003, which includes the five months preceding March 1, 2003, the effective date of DHS' operations as an entity. We were unable to apply to the information certain procedures prescribed by professional standards within the timeframe established by OMB, because of the limitations on the scope of our audit, as described in the previous paragraphs of this section or our report. However, in fiscal year 2004, we noted that DHS did not present as RSI a schedule of budgetary resources by major budgetary account, as required, and DHS did not reconcile nonfiduciary accounts with its trading partners, as specified by OMB requirements, which could affect the intragovernmental information presented as RSI.

The information in the Performance Information and Other Accompanying Information sections of the DHS *Fiscal Year 2004 Performance and Accountability Report* are presented for purposes of additional analysis, and is not a required part of the financial statements. The Performance Information and Other Accompanying Information sections have not been subjected to auditing procedures, and accordingly, we express no opinion on this information.

Internal Control over Financial Reporting

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect DHS's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We noted certain matters, described in Appendices I and II involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable conditions A through J presented in Appendix I are material weaknesses. Appendix II represents other reportable conditions K through M.

We noted weaknesses in the DHS' FMFIA reporting process that are reported in Appendix I within Comment C – *Financial Reporting within the Office of Chief Financial Officer and DHS Components*.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004, and accordingly, other matters involving internal control over financial reporting may have been identified and reported had we been able to perform all procedures necessary to express an opinion.

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A summary of the status of 2003 reportable conditions is included as Appendix IV.

We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of DHS and certain component entities.

Internal Controls over Required Supplementary Stewardship Information

We noted certain significant deficiencies in internal control over Required Supplementary Stewardship Information, discussed in Appendix I, that in our judgment, could adversely affect DHS's ability to collect, process, record, and summarize Required Supplementary Stewardship Information.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004, and accordingly, other matters involving internal control over Required Supplementary Stewardship Information may have been identified and reported had we been able to perform all procedures necessary to express an opinion.

Compliance and Other Matters

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described in Appendix III.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004, and accordingly, other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion.

DHS was not subject to the requirements of the CFO Act during fiscal year 2004 and, consequently, was not required to comply with the FFMIA. Therefore, we are not reporting herein on DHS's compliance with FFMIA. However, our testwork disclosed deficiencies in financial management information systems (e.g., OMB Circulars A-127, *Financial Management Systems*, and A-130, *Management of Federal Information Resources*), the application of federal accounting standards, and recording of financial transactions, related to FFMIA, that are presented in Appendices I and II.

Management's Response to Internal Control and Compliance Findings

DHS management has indicated in a separate letter immediately following this report that it concurs with the findings presented in Appendices I, II and III of our report. Further, they have responded that they will take corrective action, as necessary, to ensure that the Chief Financial Officer and the respective bureau management within DHS address the matters presented herein.

Responsibilities

Management's Responsibilities. The *Accountability of Tax Dollars Act of 2002* requires DHS to obtain annual financial statement audits.

DHS management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparing Management's Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information; and
- Complying with laws, regulations, contracts, and grant agreements.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

Auditors' Responsibilities. As discussed in our report on the financial statements, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying financial statements of DHS as of and for the year ended September 30, 2004. We considered the limitations on the scope of our work in forming our conclusions.

Relating to the 2003 financial statements presented herein, our responsibility is to express an opinion on the consolidated balance sheet of DHS as of September 30, 2003, and the related statement of custodial activity for the seven months ended September 30, 2003, based on our audit. Except as discussed in our report on the financial statements, we conducted our 2003 audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated balance sheet and statement of custodial activity are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall consolidated financial statement presentation.

We believe that our 2003 audit provides a reasonable basis for our report on the consolidated balance sheet and the related statement of custodial activity as of and for the seven months ended September 30, 2003.

In connection with our fiscal year 2004 engagement, we considered DHS's internal control over financial reporting by obtaining an understanding of DHS's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our engagement was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon. Further, other matters involving internal control over financial reporting may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004.

As required by OMB Bulletin No. 01-02, in fiscal year 2004, we considered DHS's internal control over Required Supplementary Stewardship Information by obtaining an understanding of DHS's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon. Further, other matters involving internal control over Required Supplementary Stewardship Information may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004

OMB Bulletin No. 01-02 requires auditors, with respect to internal control related to performance measures determined by management to be key and reported in the MD&A, to obtain an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal controls over performance measures and, accordingly, we do not provide an opinion thereon. As discussed in our report on the financial statements, we did not apply procedures to the MD&A and performance measures presented in the DHS *Fiscal Year 2004 Performance and Accountability Report*.

In connection with our fiscal year 2004 engagement, we performed tests of DHS's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the DHS. We also note that while OMB Bulletin No. 01-02 requires certain testing and reporting on the compliance requirements of FFMIA, DHS is not subject to those requirements, and as a result, testing for compliance with FFMIA requirements was not an objective of our engagement. Further, other matters involving compliance with laws, regulations, contracts, and grant agreements may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement and, accordingly, we do not express such an opinion.

Distribution

This report is intended for the information and use of DHS management, DHS Office of Inspector General, OMB, GAO, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 8, 2004

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A. Financial Management Structure

Background: The Chief Financial Officer (CFO) and his staff have been challenged by a myriad of issues since the inception of the Department of Homeland Security (DHS), many of which are one-time, unique matters, related to the set-up of the consolidated financial processes of DHS as a single operating entity. Management has taken several positive steps toward financial integration of a diverse group of operating components. However, despite the achievements and progress made in fiscal year (FY) 2004, the CFO has acknowledged that much work remains to complete a fully integrated financial management and reporting structure to accommodate all transferred agencies and programs and to fully support the DHS mission.

Conditions: The conditions described below are structural in nature and rise to the level of a material weakness because they affect the process that controls the overall integrity of DHS' consolidated financial statements, at a time when DHS has a number of other material weaknesses and reportable conditions that affect financial reporting. Under the current financial reporting structure, the Office of the Chief Financial Officer (OCFO) prepares financial statements only at the DHS consolidated level, from trial balances submitted by the bureaus to the OCFO. The bureaus are not required to prepare complete financial statements with footnotes and supplementary data that comply with generally accepted accounting principles (GAAP). The OCFO has minimal staff to consolidate the data received directly from the bureaus, ensure consistent accounting treatment for similar transactions among the bureaus, develop consolidated footnote and supplementary data and perform quality control procedures. The vast majority of DHS' financial reporting resources have remained decentralized at the bureau level.

During FY 2004 we noted the following conditions that affected the OCFO's ability to effectively manage the consolidated financial reporting process. The OCFO has not:

- Fully developed processes that bridge the gap between where DHS' consolidated reporting responsibilities lie (at the OCFO), and where most accounting resources and detailed bureau accounting knowledge needed to ensure accurate financial statements reside (at the bureaus);
- Hired or contracted a sufficient number of personnel with the experience and skills to properly perform and supervise financial reporting functions of an Executive Branch department. This condition also has been an impediment to the adoption of effective management and oversight practices, including the ability to separate workload among OCFO staff to allow for proper supervisory reviews and to provide appropriate back-up for key staff;
- Provided the DHS bureaus with sufficient management oversight and timely policy guidance to address accounting and reporting issues that cross multiple bureaus and affect the efficiency of bureau financial accounting and reporting operations; and
- Established sufficient internal controls over financial management and reporting processes to ensure that the five essential elements of internal control over financial reporting, as defined by the Comptroller General, are designed and operating effectively, as discussed below under *Criteria*.

Other conditions that affect the quality of financial reporting that exist in the DHS bureaus and OCFO are described in Comment C - *Financial Reporting in the Office of Chief Financial Officer and DHS Components*.

Cause/Effect: In 2004, DHS has been challenged with continuing the standing-up of a large, new, and complex Executive Branch department. The OCFO has had little time to focus on correcting deficiencies from our FY 2003 audit before being subjected to the FY 2004 audit process. Nevertheless, there remains a significant gap between the CFO's responsibility for financial management and reporting at DHS, and the sufficiency of resources to accomplish this objective.

As a result, the conditions described above continue to prevent DHS from timely preparation of accurate consolidated financial information and reports and have contributed to the conditions reported in Comment C of this Appendix. Lack of adequate processes and sufficient qualified staff or contractors at the DHS consolidated level have led management to place excessive reliance on the financial statement audit process to identify errors in accounts and deficiencies in processes and controls. DHS will continue to have difficulty complying with Federal accounting standards and requirements, and implementing appropriate internal control as defined by the Comptroller General, until the structure of the financial reporting process is fully assessed and adequate resources are provided to the OCFO.

Criteria: The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government (Standards)*. The GAO defines internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Further, the GAO *Standards* identify five standards to be implemented: control environment, risk assessment, control activities, information and communication, and monitoring. These standards cover controls such as human capital practices, supervisory reviews, segregation of duties, policies, procedures, and monitoring.

Recommendations: We recommend that the OCFO:

a) Assess the structure and resourcing of the DHS financial reporting process and make appropriate improvements. These improvements could include establishing much stronger quality control processes at the OCFO, improving the policy guidance provided to DHS bureaus, and considering the benefits of requiring individual bureaus to prepare financial statements according to GAAP;

b) Hire or contract additional accounting personnel that possess complementary technical skills to perform and supervise reporting and quality control functions, including monitoring of bureau reporting processes;

c) Continue the hiring process for a Deputy CFO who possesses the knowledge to assist the CFO in driving internal controls and best practices into department and bureau financial management operations. In addition, the Deputy CFO should have extensive knowledge of GAAP, as it applies to Federal entities, and the GAO's *Standards*;

d) Be more active in identifying and promptly addressing intra-bureau financial management and reporting issues, especially where bureau financial managers do not have sufficient authority or jurisdiction to resolve matters; and

e) Perform an evaluation of the consolidated financial reporting process, using the criteria defined by the Comptroller General, to ensure that financial processes are designed and implemented with proper internal control, including the five essential control elements (i.e., control environment, risk assessment, control activities, information and communication, and monitoring). Further, consolidated and bureau level financial statement audits cannot be relied upon as an internal control.

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B. Financial Management and Oversight at Immigration and Customs Enforcement

Background: Immigration and Customs Enforcement (ICE) is a significant bureau of DHS with over $2.8 billion in annual funding. ICE was created when DHS reorganized the legacy Immigration and Naturalization Service (INS) and U.S. Customs Service into three new bureaus: ICE, Customs and Border Protection (CBP) and Citizenship and Immigration Services (CIS). ICE inherited its financial organization and systems from the former INS. ICE also serves as the accounting services provider for a significant number of DHS directorates and components, including: CIS, Science and Technology (S&T), Information Analysis and Infrastructure Protection (IAIP), DHS Management, and Border Transportation and Security (BTS) Headquarters. Together, these operations represent approximately 10 of the former 22 legacy agencies and programs that transferred to and formed DHS on March 1, 2003, and represent approximately $6.7 billion or 20 percent of the total DHS FY 2004 budget authority.

During FY 2004, ICE, CBP and CIS, referred to as the Tri-bureaus, entered into significant agreements to reorganize and exchange certain operations. For example, Border Patrol operations, and Immigration Inspection activities, including its assets and approximately 20,000 employees, were transferred to CBP from ICE. In addition, during FY 2004, ICE entered into more than 30 shared services and reconciliation agreements with various entities inside and outside DHS, for reimbursement of costs incurred on their behalf. As a result, ICE's financial reporting environment underwent significant change in FY 2004. Further, ICE experienced significant turnover in its financial personnel starting in the summer of 2003, resulting in the loss of key individuals who had important day-to-day knowledge of ICE's accounting operations and financial reporting processes.

Conditions: The conditions described below are organizational weaknesses specific to ICE's financial management. Other conditions that affect the quality of ICE's financial reporting are described in Comment C in this Appendix. We noted that during FY 2004, ICE did not have:

- A thorough, well-designed plan for transition of the accounting operations of major DHS directorates and components to its accounting systems. The transition of accounting responsibility for S&T, IAIP, and other DHS components to ICE during FY 2004 was flawed, and resulted in material errors, irregularities, and abnormal balances in the DHS consolidated financial statements that existed for most of FY 2004. The pervasiveness of the errors, in both proprietary and budgetary accounts, prevented us from completing our audit procedures for ICE and the components it serviced in FY 2004.
- In conjunction with the OCFO, a process to establish and maintain more than 30 important shared services agreements with trading partners, particularly those agreements dealing with the Tri-bureaus. The preparation of these agreements late in the fiscal year delayed ICE's receipt of cost reimbursements and contributed to significant budget difficulties. Further, the delay in preparing the agreements left little time to determine whether the allocation of expenses between the Tri-bureaus was appropriate and equitable. Many of these agreements were not executed until well into the fourth quarter of FY 2004.
- A blueprint for identifying and fixing deficiencies in its accounting and financial reporting processes, including control weaknesses, human capital needs, and information technology requirements. ICE financial systems, processes, and control activities were inadequate to provide accounting services for itself and five other major DHS operating units. Responsibility for financial reporting was fragmented among multiple organizations and offices, leading to a lack of communication and coordination within ICE.

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- Sufficient leadership and guidance, both from the OCFO and within its own management ranks, particularly given FY 2004 changes and difficult circumstances, and it lacked sufficient numbers of qualified financial managers and staff to fulfill its accounting responsibilities. ICE fell seriously behind in performance of even basic accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting, which prevented it from submitting timely and accurate periodic financial reports to DHS during FY 2004. Specifically, during FY 2004 ICE financial managers and staff did not:
  - Correctly apply Federal accounting standards, in many instances, to ensure accurate and reliable financial reporting. ICE was unable either to determine or record the proper entries to its accounts to make them balance correctly and at the end of the year had to rely on the OCFO's general ledger accountant to make the entries for them.
  - Develop and communicate accounting policies and procedures throughout ICE and the components it serviced to ensure accuracy and consistency in financial reporting, particularly for significant account balances such as intragovernmental and intradepartmental receivables and payables, accounts payable and undelivered orders, and environmental, legal, and post-employment benefits information;
  - Timely respond to data requests from the OCFO during the year; and
  - Establish adequate internal controls to reasonably ensure the integrity of financial data and that adhered to GAO's *Standards*. For example, there were insufficient supervisory reviews for journal entries made to the general ledger.

Cause/Effect: Several events during FY 2004 led to the above conditions. The combination of these events, together with managing and accounting for its own daily operations, severely taxed the resources of ICE. Specifically,

- ICE absorbed substantial additional workload in FY 2004 by taking on the accounting functions for several major DHS components and implementing the reorganization creating the Tri-bureaus, with the attendant transfer-in and transfer-out of operations and assets;
- ICE was required to establish significant shared services agreements both within and outside DHS. However, ICE was unable to get agreement on significant reimbursable amounts from the other DHS bureaus until late in the fiscal year;
- The accounting records and data of other DHS components transferred to ICE from legacy agencies during FY 2004, i.e., components of S&T and IAIP were not well organized, lacked detail support for balances, were not always reconciled, and were not timely delivered to ICE. In addition the decision to transfer the accounting functions of legacy agencies was not finalized until late in FY 2003, leaving little time to thoroughly plan the FY 2004 transition;
- ICE experienced turnover in several key accounting positions starting in the summer of 2003, and had insufficient resources throughout the year to properly address many of these conditions; and
- ICE did not significantly modify its procedures to meet the FY 2004 accelerated reporting deadlines.

It should also be noted that, although the DHS CFO became involved in addressing the disagreements among the Tri-bureaus related to shared services, agreements were not reached until late in the fiscal year, after absorbing much management attention and creating much uncertainty for ICE during the fiscal year.

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Further, the OCFO was unable to provide sufficient timely assistance to help address the other conditions cited above in a timely manner.

The current conditions at ICE indicate a void in its financial management infrastructure that likely will continue to jeopardize the integrity of DHS financial reporting until the fundamental issues of process and internal control, which includes management, human capital, and oversight, have been addressed. These conditions extend to the integrity of accounting data that is used to track the obligation and expenditure of appropriated amounts. ICE management has inappropriately placed reliance on the external audit process to identify errors and control deficiencies. Due to a lack of resources, ICE management has become reactive rather than proactive in addressing accounting errors and problems and has fallen behind in their plan for building sound financial management and systems infrastructure.

Criteria: FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO's *Standards*. According to these standards, management should ensure that they have an organizational structure that supports the planning, directing, and controlling of operations to meet agency objectives; clearly defines key areas of authority and responsibility; and provides for appropriate lines of reporting. Management is to identify the knowledge and skills needed for various jobs and establish good human capital practices. The standards also define internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

Recommendations: We recommend that ICE, in coordination and with the assistance of the OCFO:

a) Develop additional detailed accounting policies and procedures governing all areas of its financial management process. These procedures should be specific enough to be considered a blueprint for performing the accounting operations for ICE, as well as for all of the bureaus for which it provides accounting services;

b) Establish policies and procedures to obtain agreement on all shared services agreements among the Tri-Bureaus within the first quarter of the fiscal year. The OCFO must also maintain a leadership role in the process, to ensure the agreements are executed timely and equitably;

c) Perform a comprehensive internal control self-assessment to identify areas where its financial operations are not compliant with FMFIA, GAO's *Standards*, and OMB Circular A-127, *Financial Management Systems*; and

d) Hire and develop accounting staff with appropriate skills to implement and maintain an effective financial reporting process and internal controls that will ensure the integrity of financial data submitted monthly to the OCFO.

C. Financial Reporting in the Office of Chief Financial Officer and DHS Components

Background: Financial reporting at DHS is dependent upon the quality of financial reporting at its individual bureaus and the ability of the OCFO to consolidate information timely and consistently. The consolidation process is accomplished, in large part, by using the Department of the Treasury's (Treasury) *Treasury Information Executive Repository* (TIER), a data warehouse through which DHS bureaus submit their financial information. TIER interfaces with the CFO Vision software, which is used to prepare DHS consolidated and individual bureau financial statements. The OCFO is using TIER as a temporary system

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solution until a permanent financial reporting system architecture for DHS can be implemented, which is currently under development and known as the "*eMerge2*"[1] program.

The OCFO, working with the bureaus and the auditors, developed a timeline of activities, including TIER submission dates that should have allowed us to complete our audit work by the accelerated November 15, 2004 reporting deadline. The audit plan depended significantly on the preparation of a draft Section 2, *Financial Information*, of the Performance and Accountability Report (PAR)[2], based on accurate June 30, 2004 balances and its submission to us by late July.

Conditions: We noted the following internal control weaknesses related to financial reporting in the OCFO and DHS bureaus:

1. The OCFO did not:

   - Adhere to the schedule set early in the audit process to successfully meet the accelerated reporting deadline of November 15, 2004. For example, the OCFO could not prepare timely June 30 financial statements because some bureaus did not meet the agreed-upon submission dates, and fell behind in preparing the requested portions of a draft Section 2.
   - Prepare a balanced[3] consolidated financial statement until November 2004. In addition, the consolidated financial statement disclosures and notes contained critical flaws, inconsistencies and errors when provided to us approximately one week before the filing deadline of November requiring material adjustments to correct.
   - Prepare accurate periodic, e.g., quarterly, consolidated financial statements, as required by OMB, and FACTS II[4] submissions, as required by Treasury, due primarily to delays in bureau submissions of TIER inputs. Our review of the quarterly submissions also indicated that the OCFO made adjustments to the quarterly FACTS II submissions, often without support, to ensure validity checks would be met.
   - Implement sufficient procedures and monitoring controls to ensure that monthly TIER submissions received from bureaus were prepared timely and accurately. The OCFO performed only limited data quality and reasonableness checks for TIER and CFO Vision input and output, and did not require the bureaus to verify the accuracy of financial reports produced by TIER. The OCFO has not required the bureaus to use recently installed TIER analytical tools to improve the integrity and reliability of financial data at the bureau.
   - Implement sufficient monitoring control procedures to verify that bureaus were complying with its financial reporting policies and procedures relating to all elements of the DHS PAR, including the financial statements, related notes, Management's Discussion and Analysis (MD&A), RSI, RSSI, and other financial reporting matters, such as proper identification and reconciliation of intra-departmental eliminating entries. Also, the instructions issued by the OCFO did not

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[1] ***eMerge***[2] stands for "Electronically Managing Enterprise Resources for Government Effectiveness and Efficiency".
[2] PAR Section 2 contains: the financial statements with note disclosures, Required Supplementary Information (RSI), and Required Supplementary Stewardship Information (RSSI).
[3] Balanced in this context means: assets equal liabilities plus net position, on a consolidated basis, as presented on the balance sheet.
[4] FACTS II stands for *Federal Agencies' Centralized Trial-Balance System II*. FACTS II is a Treasury computer program that allows agencies to submit to Treasury one set of accounting data. Reports produced from this data include adjusted trial balances and budgetary reports.

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address unique reporting considerations existing in some bureaus. Further, the OCFO was late to require the bureaus to complete the GAO's *Checklist for Federal Accounting, Reporting, and Disclosures*, and as a result, several bureaus were late with these submissions.

- Implement procedures and related controls that will ensure accuracy and completeness in the FMFIA reporting process. In addition, we noted that DHS has not reported some material weaknesses that we have reported herein. We also noted a lack of timeliness in reporting by some bureaus, and corrective actions and milestones were not presented for some findings.

2. Coast Guard:

   - The financial reporting process is complex and labor-intensive and requires a significant number of "on-top" adjustments (adjustments made outside the core accounting system for presentation of financial information given to DHS for consolidation). In addition there is a significant amount of manual integration of data from three separate general ledger systems and corrections to overcome system and process deficiencies;
   - The processes that finance center personnel used for making year-end closing entries did not consistently include sufficient supporting documentation or internal controls at an appropriate level, such as management review and approval of individual adjusting entries. In addition, the software application used to record on-top adjustments did not consistently include the reason codes for individual entries;
   - The accuracy of financial information is highly dependent on the knowledge and experience of a limited number of key financial personnel, rather than on clearly documented procedures manuals and process flow documentation; and
   - Weaknesses in financial management oversight hinder its ability to prepare accurate, complete, and timely financial information for consolidation into the DHS financial statements. As described above and in the rest of this Appendix, we noted weaknesses related to the financial reporting process; maintenance and quality of financial records; policies and procedures; and the application of some aspects of financial accounting standards.

3. ICE, Emergency, Preparedness and Response (EPR) and the Office of State and Local Government Coordination and Preparedness (SLGCP, formerly the Office for Domestic Preparedness) have not adopted rapid close procedures to ensure that accurate and timely TIER submissions are consistently performed during the year. Similar to last year, policies and procedures for exporting data from the general ledger for periodic TIER submissions were not documented, quality control reviews of financial reports were not regularly performed, documentation of on-top adjustments was lacking, and/or TIER input was not routinely reconciled with CFO Vision output provided by the OCFO.

4. Coast Guard, SLGCP, and ICE did not have effective financial information systems or sufficiently documented processes to accumulate present cost data by DHS strategic goal, as required by Statement of Financial Accounting Standard (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards*. In addition, these bureaus, and EPR, did not have documentation to support the process to validate that the full cost by strategic goal, as presented in the notes to the consolidated financial statements, was materially consistent with actual costs incurred.

5. At EPR, the monthly TIER submissions did not accurately and completely reflect the financial transactions of the Strategic National Stockpile (SNS). By law, EPR did not have full control over the accounting process for the SNS, and it was unable to implement an effective process to obtain financial information from other Federal entities involved in the management and administration of

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the SNS. Consequently, EPR and the OCFO estimated and recorded financial activity, e.g., expenses, based on budgets instead of actual transactions, and used estimates to record certain amounts of the net SNS transfer-out balance presented in the statement of net position, which could not be substantiated with actual source documentation supporting the balances.[5]

6. Through a reimbursable agreement, SLGCP's legacy agency provides financial processing and reporting services to SLGCP.[6] Although SLGCP management has been involved in the FY 2004 financial statement audit process, they are not actively involved in the financial reporting of SLGCP activities. In addition, SLGCP has not obtained a thorough understanding of control activities over the financial reporting processes performed by its accounting services provider on its behalf.

A further discussion of ICE's financial reporting problems is given in Comment B - *Financial Management and Oversight at Immigration and Customs Enforcement.*

Cause/Effect: The OCFO and bureau financial management continued to restructure accounting and financial reporting processes during FY 2004, however, late submission of the DHS FY 2003 PAR coupled with accelerated reporting in FY 2004 left the OCFO and bureau financial managers little time to make substantial changes and improve controls before this year's audit cycle began. The financial reporting weaknesses at the OCFO can be attributed directly to weaknesses described in Comment A, *Financial Management Structure*. As already described above, some bureaus have not developed adequate policies and procedures to perform a rapid close of monthly activity and accurately export data from the general ledger for periodic TIER submissions. This has caused errors and delays in DHS financial reporting. The conditions at Coast Guard have surfaced because of Coast Guard's greater relative size within DHS. Coast Guard will need time, appropriate skilled personnel, and resources to correct these weaknesses.

EPR was unable to adequately maintain financial records for the SNS because it did not have full control over the process. Four different Federal entities played a role in SNS accounting. Because all of these entities were unable to coordinate a timely reconciliation of their records and activities, EPR was unable to maintain accurate balances for SNS' obligations, undelivered orders (UDOs), operating expenses, inventory, and accounts payable during FY 2004. SNS was transferred out of DHS to the Department of Health and Human Services in August 2004.

Regarding the presentation of cost data by responsibility segment and major program, most DHS bureaus use financial management systems developed several years ago, before the creation of DHS and well before DHS adopted its strategic goals. Consequently, many information systems do not contain financial data in a format that facilitates full compliance with SFFAS No. 4, e.g., the allocation of costs to programs and reporting of costs by strategic goal within the DHS structure. As a result, many bureaus must perform manual analyses and computations to comply with this accounting standard.

SLGCP places a significant amount of reliance on the legacy agency to process and report its transactions because it lacks resources to perform effective oversight of the financial reporting process and related control activities performed on its behalf. As a result, SLGCP lacks assurance that the processing of its financial activities coincides with its business operations and are accurately reported and properly controlled.

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[5] By law, SNS was transferred to the Department of Health and Human Services in August 2004.
[6] The Office of Justice Programs, a component of the Department of Justice, is SLGCP's legacy agency, and also referred to herein as SLGCP's accounting services provider.

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Independent Auditors' Report
Appendix I – Material Weaknesses in Internal Control

Criteria: FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards*. These standards define internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The GAO *Standards* require that internal controls be documented in management directives, administrative policies, or operating manuals; transactions and other significant events be clearly documented; and information be recorded and communicated timely with those who need it within a timeframe that enables them to carry out their internal control procedures and other responsibilities. According to these standards, the five essential control elements are: control environment, risk assessment, control activities, information and communication, and monitoring.

Recommendations: We recommend that:

1. The OCFO:

   a) Obtain the necessary skills and resources, through appropriate human resource practices or contracting, to ensure it meets internal deadlines that are part of the accelerated reporting timeline, to assist the bureaus to do the same, to meet and properly support other quarterly external reporting deadlines, and to advise the bureaus as described in b) below;

   b) Assist the bureaus with an assessment to determine the reasons for TIER reporting delays; provide management oversight to correct weaknesses; streamline the reporting process; and enhance reporting efficiency in the bureaus;

   c) Establish written policies and procedures that, through implementation, will provide reasonable assurance that the inputs and outputs to and from TIER and CFO Vision are materially accurate and complete. These procedures should include periodic Bureau reconciliations of TIER inputs to TIER-produced trial balances and CFO Vision Bureau financial statements, timely confirmations to the OCFO that such reconciliations have been completed and reconciling items have been resolved. Conduct training on the use of TIER analytical tools to improve the integrity of financial data submitted to the OCFO;

   d) Develop and implement monitoring controls that will ensure that the bureaus comply with the DHS financial reporting policies and procedures for the PAR, including financial statements and notes, MD&A, RSI, RSSI, and other financial reporting matters. Implement an OCFO process to prepare financial statements and notes, MD&A, RSSI and RSI that are in full compliance with required reporting standards. This process should include at a minimum the bureaus' completion of GAO's *Checklist for Federal Accounting, Reporting, and Disclosures,* in time to prepare an up-to-date draft PAR Section 2 according to the internal accelerated reporting timeline. The bureaus should have a significant role and responsibility in preparing and reviewing the completed PAR. The checklist is a tool to help the OCFO prepare financial statements according to GAAP, and it is particularly needed in this decentralized reporting environment and in the absence of other adequate controls; and

   e) Provide instruction and management oversight of the FMFIA evaluation process to improve comprehensiveness of review, coordination with the external audit process, and consistency in reporting by the bureaus.

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2. Coast Guard:
   a) Conduct an assessment of its current financial reporting process, with the goal of implementing appropriate internal controls and reducing complexity;
   b) Improve documentation for year-end closing entries, including management review and approval and clear identification of all on-top adjustments with all associated account entries;
   c) Reduce the reliance on the limited number of key personnel by cross training personnel and documenting the financial reporting process;
   d) Develop procedures and internal controls for providing oversight and guidance for operating units, and program offices that provide key financial information; and
   e) Evaluate the existing financial management organizational and internal control structure and conduct an assessment to determine the number of personnel needed along with requisite skills and abilities and make improvements as indicated.
3. ICE, EPR, and SLGCP:
   a) Conduct an assessment of the monthly closing process to identify and correct weaknesses that impede timely and efficient reporting processes; reduce the number of on-top adjustments and improve documentation for them; improve integration of information systems; and design a quicker, more accurate monthly closing process and TIER submission. Perform regular quality control reviews of financial reports;
   b) Reconcile CFO Vision financial statements to TIER input on a monthly basis, with differences investigated and resolved;
   c) Cross-train additional personnel in the financial reporting and TIER submission process, especially in the quality assurance review of the data submitted, to ensure that sufficient resources are available to assist at peak financial reporting periods; and
   d) Document key Standard Operating Procedures (SOPs) for significant financial reporting processes.
4. Coast Guard, EPR, SLGCP, and ICE should consider modifying information systems, or if not feasible, develop manual processes, to accumulate, present, and validate cost data by DHS strategic goal, as required by SFFAS No. 4. SLGCP should work with its legacy agency to develop automated or manual processes to accumulate and present cost data by DHS strategic goal. These bureaus should thoroughly document the process beginning with data sources through preparation and delivery of the note disclosure to the OCFO at a level of detail appropriate to fully define and document all internal controls embedded in the process.
5. SNS was transferred to HHS on August 13, 2004, and consequently, we have not included recommendations for management related to SNS.
6. SLGCP should designate an official to perform a financial oversight role and take responsibility for monitoring the financial processing and reporting activities performed by the accounting services provider on SLGCP's behalf.

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D. Financial Systems Functionality and Technology

Background: Controls over information technology (IT) and related financial systems are essential elements of financial reporting integrity. Effective general controls in an IT and financial systems environment are typically defined in six key control areas: entity-wide security program planning and management, access control, application software development and change control, system software, segregation of duties, and service continuity. In addition to reliable controls, financial management system functionality is important to program monitoring, increasing accountability of financial and program managers, providing better information for decision-making, and increasing the efficiency and effectiveness of services provided by the Federal government.

During FY 2004, DHS took many actions to improve its IT general control environment and to address prior year general IT control issues. For example, DHS implemented an automated security certification and accreditation (C&A) tool and improved its software change control policies and practices. In addition, during FY 2004 DHS awarded a contract for the eMerge[2] program, which will help consolidate financial management and IT activities across DHS. Despite these improvements, as in FY 2003, we again identified significant general IT control weaknesses related to financial reporting at DHS and its bureaus, which, collectively, limit DHS' ability to ensure that critical financial and operational data is maintained in a manner to ensure confidentiality, integrity, and availability.

Conditions: As in FY 2003, we noted the following IT and financial system control and functionality weaknesses at DHS and its bureaus:

1. Regarding entity-wide security program planning and management, we noted:
   - Despite the implementation of an automated tool to assist with the DHS security C&A efforts, such efforts were still not completely implemented in a manner that ensures the detection and prevention of technical security weaknesses;
   - Security training and awareness programs, especially those related to the detection and prevention of technical weaknesses, can be improved;
   - Security plans did not consistently document existing system security controls, were incomplete, or otherwise did not meet requirements set forth in OMB Circular A-130, *Management of Federal Information Resources*; and
   - Security risk assessments were not regularly performed and were not performed consistently.
2. Regarding access controls, we noted:
   - Instances of missing user passwords on key servers and databases, weak user passwords, and weaknesses in user account management. Also, we noted several cases where user accounts were not periodically reviewed for appropriateness, including authorizations to use group user accounts and excessive access privileges; and
   - Instances where workstations, servers, or network devices were configured without necessary security patches, or were not configured in the most secure manner. We also identified many user accounts that were not configured for automatic log-off or account lockout.

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3. Regarding system software, we noted:
   - Instances where policies and procedures for restricting and monitoring access to operating system software were not implemented, or were inadequate. In some cases, the ability to monitor security logs did not exist; and
   - Changes to sensitive operating system settings were not always documented.
4. Regarding segregation of duties, we noted:
   - Instances where individuals were able to perform incompatible functions, such as the changing, testing, and implementing software, without sufficient compensating controls in place; and
   - Instances where key security positions were not defined or assigned, and descriptions of positions were not documented or updated.
5. Regarding service continuity, we noted:
   - Several bureaus had incomplete business continuity plans and systems with incomplete disaster recovery plans. Some plans did not contain current system information, emergency processing priorities, procedures for backup and storage, or other critical information; and
   - Some bureau service continuity plans were not consistently tested, and individuals did not receive training on how to respond to emergency situations.

Cause/Effect: Many of these weaknesses were inherited from the bureaus that came into DHS, and will take several years to fully address. Management has undertaken a complicated task of merging numerous and varying financial management systems and control environments into a DHS environment. At many of the larger bureaus, IT and financial system support operations are decentralized, contributing to challenges in integrating DHS IT and financial operations. In addition, financial system functionality weaknesses can be attributed to non-integrated legacy financial systems that do not have the embedded functionality called for by OMB Circular A-127.

Criteria: The *Federal Information Security Management Act* (FISMA), passed as part of the *Electronic Government Act of 2002*, mandates that Federal entities maintain IT security programs in accordance with OMB and National Institute of Standards and Technology (NIST) guidance. OMB Circular A-130, and various NIST guidelines describe specific essential criteria for maintaining effective general IT controls. In addition, OMB Circular A-127 prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems. In particular, OMB Circular A-127 specifies the need for integrated financial systems and to account for financial data using the USSGL at the transaction level.

Recommendations: DHS needs to place further emphasis on the monitoring and enforcement of policies and procedures through the performance of periodic security control assessments and audits. Focus should be placed on implementing and enforcing a DHS-wide security C&A program, and technical security control training for system administrators and security officers. Many of the technical issues identified during our review, which were also identified during FY 2003, such as weak technical security controls and the lack of contingency planning, can be addressed through a more effective security C&A program and security training program.

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We recommend that DHS:

1. For entity-wide security program planning and management, ensure that:
   a) Implementation and enforcement of the C&A program continues;
   b) A DHS-wide security training and awareness program is designed and implemented consistent with OMB and NIST guidance. A key focus of the training program should be on the detection and prevention of technical weaknesses;
   c) Information security planning efforts more consistently follow relevant Federal guidance (OMB and NIST);
   d) Security risk assessments are completed in a consistent manner per OMB and NIST guidance; and
   e) The above recommended entity-wide security efforts are implemented in a consistent manner across bureaus.
2. For access control, ensure that:
   a) Password controls meet DHS password requirements and are enforced on all systems;
   b) A password account management process is implemented within the bureaus to ensure the periodic review of user accounts;
   c) A DHS-wide patch and security configuration process is designed and implemented;
   d) A vulnerability assessment process is implemented, whereby systems are periodically reviewed for security weaknesses; and
   e) The above recommendations are included as part of the DHS C&A program.
3. For system software, ensure that bureau personnel comply with the established policies and procedures for monitoring, use, and changes related to operating systems.
4. For segregation of duties, ensure that:
   a) Responsibilities are documented so that incompatible duties are consistently separated. If this is not feasible given the smaller size of certain functions, then sufficient compensating controls, such as periodic peer reviews, should be implemented; and
   b) Policies and procedures are developed and documented to assign key security positions and maintain current position descriptions.
5. For service continuity, ensure that:
   a) Bureaus develop and implement complete business continuity plans and system disaster recovery plans;
   b) Bureau-specific and DHS-wide testing of key service continuity capabilities are performed; and
   c) A DHS-wide service continuity training program is designed and implemented.

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E. Fund Balance with Treasury

Background: Fund Balance with Treasury (FBWT) represents accounts held at Treasury from which an agency can make disbursements to pay for its operations. Regular reconciliation of an agency's records with Treasury for FBWT is essential to monitoring and safeguarding these funds, improving the integrity of various U.S. Government financial reports and providing a more accurate measurement of budget resources and status. FBWT at ICE, and the other DHS bureaus it services, and the Coast Guard totaled approximately $6.8 billion or 14 percent of total DHS assets at September 30, 2004. The majority of these funds represented appropriated amounts that were obligated but not yet disbursed at September 30, 2004.

Conditions: We noted the following internal control weaknesses related to FBWT:

At ICE and Coast Guard:

- Did not complete timely reconciliations of their FBWT accounts during the year, as required by the Treasury Financial Manual (TFM), by performing all of the required procedures to completely reconcile FBWT, including reconciliations to FMS 6652, *Statement of Differences*; FMS 6653/54 *Undisbursed Appropriation Account Ledger/Trial Balance*; SF 224 *Statement of Transactions*; and/or FMS 6655 *Receipt Account Trial Balance/Ledger*, and did not clear items carried in suspense clearing accounts timely during the year. At times, hundreds of unresolved items were carried in suspense, some of which were more than a year old, totaling several hundred million dollars in unreconciled balances; and
- Lacked written SOPs to direct and document the correct reconciliation processes and internal controls to ensure that monthly collection and disbursement activity were reported accurately and timely to the Treasury.

Cause/Effect: Turnover in key personnel and a general lack of appropriate resources contributed to the FBWT reconciliation conditions at ICE. The Coast Guard did not complete timely reconciliations because of continued difficulties in overcoming the FY 2003 implementation of a new financial system. Although by September 30, 2004, the Coast Guard had completed their FBWT reconciliation, they had not completed the reconciliation timely during the year. Failure to implement timely and effective reconciliation processes could increase the risks of fraud and mismanagement of funds; lead to inaccurate financial reporting; and affect the Government's ability to effectively monitor the status of its budget.

Criteria: The TFM[7] states, "Federal agencies must reconcile their Standard General Ledger (SGL) account No.1010 and any related sub-accounts, with the FMS 6652, 6653, 6654 and 6655 on a monthly basis (at minimum). They must review those accounts each month to maintain the accuracy and reliability of their fund balance records for both prior year and current year appropriations. Agencies must reconcile no-year, revolving, deposit and trust fund accounts. They also must reconcile clearing and receipt accounts. This detailed reconciliation assures that agency data accumulated in the fund balance account is accurate. It also allows the agency to resolve differences in a timely manner. Federal agencies must research and resolve differences reported on the monthly FMS 6652. They also must resolve all differences between the balances reported on their general ledger FBWT accounts and balances reported on the FMS 6653, 6654 and 6655. When resolving differences, agencies should maintain detailed reconciliation worksheets that, if needed, can be reviewed by the Agency's auditors or Treasury." TFM

[7] TFM, Supplement I TFM 2-5100 (November 1999)

(Continued)

Section 5145, *Reconciling Budget Clearing Account Differences*, states, "Agencies must reconcile all Budget Clearing Account Balances, including F3875 accounts. They must reclassify these balances to appropriate Treasury account symbols." TFM Section 5125 – *Background*, specifies the procedures to be performed when reconciling FBWT.

Recommendations: We recommend that ICE and the Coast Guard:

a) Prepare monthly reconciliations of FBWT, including resolution of differences;

b) Perform all procedures required by the TFM including sections 5125, 5145 and Supplement I TFM 2-5100;

c) Research and clear items held in suspense promptly during the year. Typically, significant balances should not be held in suspense more than 30 days; and

d) Develop and implement written SOPs to direct and document their FBWT reconciliation processes. The SOPs should be based on Treasury guidance and tailored to the bureaus' operations and financial accounting systems. The procedures should also include timely reviews by supervisory personnel.

F. Property, Plant, and Equipment

Background: Property, plant and equipment (PP&E) represents approximately 17 percent of total DHS assets and more than 60 percent of non-monetary assets. DHS uses a wide variety of capital assets to accomplish its mission, some of which are not typically maintained by non-defense agencies, such as aircraft, and boats and vessels. These assets often have long useful lives, and undergo extensive routine servicing that may increase their value or extend their useful lives. In addition, DHS has several internal use software development projects underway that will result in capitalized software balances in future years. Consequently, application of proper accounting standards to account for PP&E is important to the accuracy of DHS' consolidated financial statements.

Conditions: We noted the following internal control weaknesses related to PP&E at DHS bureaus:

1. Coast Guard has not:

- Implemented appropriate controls and related processes to properly, accurately, and timely record PP&E additions, transfers from other agencies, and disposals in its fixed asset system;
- Developed and documented methodologies and assumptions to support the value of PP&E that is not supported by original acquisition or other documentation;
- Implemented asset identification and tagging processes that include sufficient detail, e.g., serial number, to clearly differentiate and accurately track assets in the fixed asset system. In addition, the Coast Guard lacks adequate procedures to update movements and change in status of PP&E in a timely manner, e.g., active or inactive, including those related to the Integrated Deepwater System Program (Deepwater) and vessels that are under repair or being converted;
- Developed an effective physical inventory process and appropriate support for the valuation method and classification of repairable PP&E;
- Properly accounted for some improvements and impairments to buildings and structures, and selected useful lives for depreciation purposes, consistent with GAAP; and

- Established procedures to identify and evaluate lease agreements to determine proper classification and accounting as either capital or operating.

2. ICE has not consistently applied procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development. At September 30, 2004, software costs were not considered material to the consolidated financial statements; however, software development costs are expected to increase in future years.

Cause/Effect: Coast Guard has implemented policies and procedures affecting PP&E; however, they are lacking in comprehensiveness and, therefore, do not provide reasonable assurance that all transactions affecting PP&E will be accounted for consistent with GAAP. In addition, the fixed asset module of the Coast Guard's core accounting system is not updated for effective tracking of all PP&E and its capabilities are not fully utilized to clearly differentiate and accurately track assets. The Coast Guard also lacks sufficient policies and procedures and documentation for PP&E. As such, we were unable complete audit procedures over approximately $2.6 billion of PP&E.

ICE lacks sufficient SOPs that clearly define accounting policies for software development costs. Over the next few years, ICE anticipates spending significant resources developing new software, such as US VISIT. Therefore, the lack of SOPs would increase the risk of financial statement errors due to misapplication of accounting standards for software.

Criteria: SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, requires that:

- PP&E be recorded at historical cost with an adjustment recorded for depreciation. In the absence of such information, estimates may be used based on a comparison of similar assets with known values or inflation-adjusted current costs;
- Leases be valued at inception to determine the proper accounting treatment as either a capital or operating lease; and
- PP&E accounts be adjusted for disposals, retirements and other removal of PP&E, including associated depreciation.

SFFAS No. 10, *Accounting for Internal Use Software*, provides requirements for the capitalization and reporting of software development costs. GAO's *Standards* require that internal control and all transactions and other significant events are clearly documented and readily available for examination. The Joint Financial Management Improvement Program (JFMIP) *Property Management Systems Requirements,* states that the Agency's property management system must create a skeletal property record or have another mechanism for capturing information on property in-transit from the providing entity (e.g., vendor, donator, lender, grantor, etc.).

Recommendations: We recommend that:

1. Coast Guard:

   a) Improve controls and related procedures to ensure that additions, transfers, and disposals are recorded accurately and timely in the fixed asset system; that the serial number is entered in the fixed asset system at the time of asset purchase to facilitate identification and tracking; and that the status of assets is accurately maintained in the system;

   b) Develop and document methodologies and assumptions to support the value of PP&E that is not evidenced by original acquisition or otherwise sufficient documentation;

(Continued)

c) Develop and implement internal controls to ensure the quality, sufficiency, and retention of documentation for future PP&E acquisitions and disposals;

d) Revise procedures for performing physical inventories of repairable items, to include procedures for resolving differences and reporting results, to ensure that repairable PP&E is accurately and completely classified and recorded. Support the pricing methodology used to value repairable PP&E to ensure that balances, as presented in the financial statements, approximate amortized historical cost;

e) Review policies and procedures to account for improvements and impairments to buildings and structures; identify proper useful lives for depreciation purposes that are consistent with GAAP; and correct material departures from GAAP; and

f) Establish procedures to ensure that lease agreements are identified and evaluated for proper classification as either capital or operating leases.

2. ICE:

a) Perform a review of its existing software capitalization policy to determine adequacy for financial reporting purposes. The policy should be sufficiently detailed to allow developers and accounting personnel to identify the various phases of the software development life cycle and the associated accounting treatment, as described in SFFAS No. 10; and

b) Develop and implement procedures for developers to track and notify accounting personnel when software has been placed into production so that accounting personnel can properly classify and amortize the software costs.

G. Operating Materials and Supplies, and Seized Property

Background: Operating Materials and Supplies (OM&S) are maintained by the Coast Guard in significant quantities, and consist of tangible personal property to be consumed in normal operations to service marine equipment, aircraft, and other operating equipment. The majority of the Coast Guard's OM&S is physically located at either two Inventory Control Points (ICPs) or in the field. The ICPs use the Naval Electronics Supply Support System (NESSS) and the Aircraft Logistics Management Information System (ALMIS) to track inventory, and field held OM&S is recorded in a different system as subsidiary records supporting the general ledger. The Coast Guard's policy requires regularly scheduled physical counts of OM&S, which are important to the proper valuation of OM&S and its safekeeping. The Secret Service is responsible for the storage, maintenance, and disposal of seized counterfeit currency.

Conditions: We noted the following internal control weaknesses related to OM&S and seized counterfeit currency:

1. At Coast Guard:

- Internal controls over physical counts at field locations were not operating effectively during FY 2004. For example, items were not always properly bar-coded or tagged and on hand quantities frequently did not agree to the perpetual inventory records, and procedures did not sufficiently address whether all inventory on hand was properly recorded in the perpetual records or require discrepancies' timely resolution. Coast Guard plans to implement corrective action over field held OM&S, to include implementation of internal controls, in FY 2005;

(Continued)

- Policies and procedures for conducting physical inventories of OM&S at the ICPs remained in draft and lacked key elements of an effective physical inventory, e.g., reconciliation of sample population to perpetual records, statistically valid methods of sampling, and proper evaluation and reporting of results. Comprehensive step-by-step physical inventory instructions that clearly addressed each objective of a physical inventory were not communicated in a clear and timely manner. In addition, we noted instances where personnel did not comply with established procedures, and did not properly report findings;
- Warehouse locations recorded in NESSS were not always current. Some locations listed in NESSS did not exist and one NESSS record could not be located; and
- The weighted average pricing methodology used to value OM&S was not appropriately supported to demonstrate that all recorded prices approximated historical cost.

2. At the Secret Service, while the counterfeit currency records reflected the results of the physical inventories, they did not accurately reflect the activity for the year.

Cause/Effect: The Coast Guard did not have sufficient time between DHS' financial statement audits to fully implement our FY 2003 recommendations related to field held OM&S. Lack of comprehensive and effective policies and controls over the performance of physical counts may result in inventory discrepancies or errors in the physical inventory process that could result in financial statement misstatements. The Coast Guard's support for the calculated weighted average pricing of OM&S included some inaccuracies, and the lack of completeness of the sampled universe might have affected the reliability of the analysis. The Secret Service inventory system did not provide the information necessary to reconcile activity during the year.

Criteria: According to GAO's *Standards*, assets at risk of loss or unauthorized use should be periodically counted and compared to control records. Policies and procedures should be in place for this process. The JFMIP *Inventory, Supplies, and Material System Requirements,* states that "the general requirements for control of inventory, supplies and materials consist of the processes of receipt and inspection. An agency's inventory, supplies and materials system must identify the intended location of the item and track its movement from the point of initial receipt to its final destination." SFFAS No. 3, *Accounting for Inventory and Related Property*, states OM&S shall be valued on the basis of historical cost.

Recommendations: We recommend that:

1. Coast Guard:
   a) Update OM&S physical count policies, procedures, and controls, and provide training to personnel responsible for conducting physical inventories;
   b) Implement effective oversight and monitoring procedures to ensure that physical inventory counts are performed and evaluated in accordance with policies and procedures;
   c) Perform a review of the inventory information contained in NESSS to identify and correct discrepancies between the perpetual records and actual physical item counts and warehouse locations;
   d) Consider developing risk-based cycle counting procedures for OM&S; and
   e) Provide adequate support for the weighted-average price used to value OM&S.
2. Secret Service update its policies and procedures to ensure that the annual activity related to counterfeit currency is properly reflected in the records in a timely manner.

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H. Undelivered Orders, Accounts and Grants Payable, and Disbursements

Background: During FY 2004, ICE began providing accounting services for several significant directorates and programs, including S&T, IAIP, Management, and BTS Headquarters, and continued as accounting service provider for CIS. Most of the prior service providers were legacy agencies outside of DHS. The legacy agencies, for at least some of the components, continued to make disbursements related to prior year obligations and some current year obligations. The legacy agencies charged ICE Treasury accounts, often without reporting the transactions to ICE. As a result, ICE had difficulty maintaining accurate records related to obligations and UDOs. UDOs represent obligations for which delivery of services or goods has not been made. Accurate UDO balances are essential to maintaining budgetary status and estimating ICE's and other components' accounts payable at year-end.

SLGCP uses its legacy agency's grants management system to support SLGCP's grant making activities. Beginning in April 2004, this system allowed grantees to submit their financial status reports electronically via web-based connections. The Transportation Security Administration (TSA) entered into a significant number of grant agreements during FY 2004. Although the management of most of these grants was transferred to SLGCP in the third quarter of FY 2004, the TSA retains administrative responsibilities for these grants until closeout.

Conditions: We noted the following internal control weaknesses related to UDOs, accounts and grants payable, and disbursements:

1. At ICE:

   - Disbursements made by legacy agencies for S&T and IAIP directorates were not identified and accounted for until the transactions were listed as differences by Treasury in monthly reports used to reconcile FBWT. Consequently, we noted that more than $200 million of disbursements were not recorded in the general ledger when they occurred;
   - ICE did not establish sufficient controls to prevent duplicate payments to vendors related to prior year obligations or to prevent temporary anti-deficient situations in certain Treasury accounts used by both ICE and the legacy agencies to make disbursements;
   - ICE did not have sufficient controls to ensure that open obligations were properly liquidated when corresponding accounts payable were recorded;
   - Policies related to verification and validation of obligations performed by field personnel did not clearly define responsibilities and have not been issued to all field locations;
   - We noted an error rate of approximately 10 percent when examining approvals for disbursements for S&T and IAIP. Specifically, evidence of review and approval of invoices and receipt of goods and services could not be located; and
   - The method used during FY 2004 to estimate accounts payable for S&T, IAIP and the other components that ICE performs accounting services for, was not based on historical disbursements or other information unique to those particular programs. In addition, subsidiary records used to compute accounts payable, i.e. Open Document File (used to track UDOs), did not agree to the general ledger during the year, however were reconciled at year end.

2. At Coast Guard:
   - Coast Guard did not have adequate controls to periodically review and validate UDOs or to ensure that recorded obligations were valid, and obligations incurred were recorded timely;
   - Coast Guard did not record contract awards related to Deepwater in the general ledger in a timely manner, resulting in an understatement of obligations approximating $105 million at the time of our testwork. In addition we noted a lack of segregation of duties associated with the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligation;
   - Facts and Figures Quick (FAFQ) programming logic was not properly configured to extract data into a report that accurately reflected the general ledger and could be used to evaluate and analyze the transaction history of UDOs;
   - The transaction codes in the Coast Guard's general ledger to record advance payments and related UDOs was not in conformance with the TFM and could result in a misstatement to the financial statements;
   - Policies and procedures related to the automated requisition and procurement process were not consistently followed in all regions. Specifically, the Financial and Procurement Desktop (FPD) system could be overridden to allow non-conforming numbering for purchase requisitions, and as a result there was a risk that commitments would not be properly tracked and/or matched with obligations in the accounting records. Further, a system problem existed that affected the synchronization of transactions recorded in FPD and the core accounting system, resulting in an overstatement of UDOs of $5.6 million that had to be corrected;
   - The Procurement Management Effectiveness Assessment (MEA), which is an on-site assessment of procurement activity for compliance with Federal statutes and regulations, was not fully performed as planned in FY 2004. The MEA is an important risk assessment and monitoring control function that, when properly performed, assists in assessing compliance with applicable laws and regulations; and
   - The verification process used to validate the accuracy of accounts payable included erroneous data. Consequently inaccurate statistics would have been used in estimating accounts payable at year-end.
3. SLGCP did not perform sufficient monitoring over the legacy agency's activities performed on its behalf. Certain control weaknesses were identified in the legacy agency's financial systems. For example, the web-based grantee reporting system was not certified and accredited. Consequently, SLGCP management did not have assurance that the system controls associated with its grant accruals and the related financial statement line items were properly designed and effectively operating.
4. At TSA several grants tested did not have the following on file: performance reports; the application package SF-424, *Application for Federal Assistance*, and SF-270, *Request for Advance or Reimbursement,* signed by the grant officer and/or the program officer. We also noted that the TSA did not have policies or procedures in place to properly monitor compliance with the *Single Audit Act Amendments of 1996* (OMB's Circular A-133) and laws and regulations supporting OMB A-50, *Audit Follow-up*, as revised.

(Continued)

Cause/Effect: Some of the conditions at ICE resulted from difficulties with the transfer of S&T, IAIP, and DHS management accounting operations from legacy agencies to ICE in FY 2004. (See Comment B - *Financial Management and Oversight at Immigration and Customs Enforcement*, for further details.) In addition, procedures for verification and validation of obligations were not clearly written and understood by field personnel. These procedural weaknesses resulted in the misclassification of open obligations and misstatements of undelivered and delivered orders.

Coast Guard's greater relative size within DHS, compared to its legacy department, has meant that it has received proportionally greater scrutiny. Because SLGCP management did not perform sufficient monitoring of its financial reporting processes, SLGCP could not take timely action to ensure that control weaknesses identified in the legacy agency's systems used to process SLGCP's transactions would not materially impact its financial statement balances. These weaknesses could result in a misstatement of grant payables, expenses and/or UDOs. At TSA, if grants are not appropriately monitored, it is possible that funding will not be used for its intended purpose.

Criteria: GAO's *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular A-123, *Management Accountability and Control*, states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports." SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, states, "When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated."

Recommendations: We recommend that:

1. ICE:
   a) Improve procedures to prevent duplicate payments to vendors from accounts used by both ICE and legacy agencies, including the proper liquidation of obligations when accounts payable are recorded. Also, establish written procedures that require legacy agencies to timely submit all information affecting ICE's accounting for component disbursements and work with legacy agencies to implement them. If possible, consider transferring all accounting services for prior year obligations from legacy agencies into ICE;
   b) Strengthen controls over the timely liquidation of obligations when accounts payable are recorded;
   c) Adhere to disbursing policies and procedures, which require disbursements to be made only after proper approval of the invoice has been obtained and evidence of the receipt of goods and services has been received;
   d) Expand the policies and procedures documentation related to obligation verification and validation to more clearly communicate the process to field personnel. The policies should be updated to require the completion of a receiving report for all goods and services before invoices are approved for payment. If necessary, additional training should occur to enhance understanding of the procedures; and
   e) Use historical data that is specific to the operations of S&T, IAIP, Management, BTS Headquarters, and CIS when estimating accounts payable for financial statement purposes. In addition, UDO subsidiary records should be routinely reconciled to the general ledger.

2. Coast Guard:
   a) Improve controls related to processing obligation transactions, to include periodic review and validation of UDOs. Emphasize to all funds managers the need to perform effective monthly reviews of open obligations. Develop effective monitoring controls for reviewing and approving obligation transactions prior to processing;
   b) Improve segregation of duties at Deepwater related to the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligations;
   c) Evaluate programming logic and transactions codes used to record advances for which an obligation was not previously recorded to ensure the obligation and UDO is properly recorded;
   d) Assess programming logic of Facts & Figures Quick and implement appropriate corrective action;
   e) Update the program logic of FPD to improve document numbering of purchase requisitions. The system design of FPD and the core accounting system should be evaluated to ensure that obligation transactions are correctly processed;
   f) Revise Commandant Instruction 4200.30B, *Program Management Review Program*, in order to implement effective oversight and monitoring procedures of the contract acquisition process, including the frequency of MEA's at major procurement regions; and
   g) Improve controls over data validation used in the accounts payable estimation process.
3. SLGCP should designate an official to perform a financial oversight role and take responsibility for monitoring its financial processing and reporting activities performed by its legacy agency. This official should obtain appropriate assurances from its legacy agency, e.g., Statement on Auditing Standards No. 70, *Service Organizations,* review report, to be able to assess that general and application controls relevant to SLGCP's financial activities are properly designed and operating effectively.
4. TSA:
   a) Implement policies and procedures to ensure that performance reports for grants and agreements are received in accordance with grant award documents and OMB's requirements;
   b) Implement policies and procedures to ensure that grantees are being monitored for compliance with OMB's Circular A-133 and A-50; and
   c) Implement document retention policies and procedures that include printing out approvals and placing them in award files, and printing out application packages when they are received.

I. Budgetary Accounting

Background: Budgetary accounts are a category of general ledger accounts where transactions related to appropriations and other authorities to obligate and spend agency resources are recorded. During FY 2004, ICE began providing accounting services for several significant directorates and programs, including S&T, IAIP, Management, and BTS Headquarters and continued as accounting service provider for CIS. Most of the prior service providers were legacy agencies outside of DHS. The Coast Guard has a complex budget that includes budget authority from a variety of sources: annual, multi-year, and no-year appropriations; and several revolving, special, and trust funds.

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Conditions: We noted the following internal control weaknesses related to budgetary accounting:

1. At ICE:

   - Weaknesses existed in controls that might have allowed ICE to become anti-deficient or prevented management from knowing if they were anti-deficient. As stated in our Independent Auditors' Report, we were unable to complete our audit of the financial statements as of and for the year ended September 30, 2004 and accordingly, we were unable to complete our procedures related to ICE's compliance with the *Anti-Deficiency Act*;
   - The transfer of accounting records and responsibilities from prior accounting services providers was not coordinated properly. FY 2003 ending balances for budgetary accounts often did not equal FY 2004 beginning balances, with the differences unexplained. The legacy agencies continued to approve payments and make disbursements for prior year obligations, but ICE was unable to get timely information on these activities, if any at all, to update the relevant accounting records;
   - Obligations were not recorded in a timely manner. For example, approximately $200 million in FY 2004 obligations for S&T were not recorded in the general ledger because of insufficient controls to prevent S&T from using its prior legacy service provider and lack of coordination. Other obligations related to S&T, IAIP, Management, and BTS Headquarters were not recorded timely in the general ledger;
   - Disbursements and resulting adjustments to obligation balances related to operations transferred to CBP, i.e., Border Patrol, were not reported timely to CBP, causing misstatements in the financial statements of both bureaus;
   - Contracting officer approvals were not clearly documented on obligating documents, and in one instance a contracting officer approved a purchase for an amount in excess of the officer's authority; and
   - Weaknesses existed in controls over the preparation, submission and reconciliation to the general ledger of the SF 132, *Apportionment and Reapportionment Schedule*, and the SF 133, *Report on Budget Execution*. Information reported on the SF-133 did not agree with the accounting records and was not reconciled timely resulting in inaccuracies in the June 2004 financial statements.

2. At Coast Guard:

   - The electronic validation and/or edit checks within the budget module of the general ledger accounting system, which could flag and prevent the recording of commitments (a reservation of funds for future obligation) or obligations in excess of appropriations, apportionments, or allotments, was not fully utilized;
   - Weaknesses existed in controls over the recording of budgetary authority, commitments, obligations and related disbursements and rescissions. For example, budget authority recorded in the Coast Guard's main general ledger system was understated by $1.2 billion as of March 31, 2004, and FY 2004 budget authority for acquisition, construction and improvements appropriations was overstated by $26 million. Coast Guard did not properly record $60 million in budget authority that was transferred from the Department of the Navy, resulting in inaccuracies in the June 2004 financial statements;

(Continued)

- Weaknesses existed in controls over the preparation, submission and document retention of the SF 132 and SF 133 reports. For example, some SF-132s combined multiple appropriations without advanced written OMB approvals;
- Approximately five percent of contracting officers listed with warrant authority had expired warrants at the time of our testwork. There were no automated system controls to preclude the processing of procurement transactions if the contracting officer's warrant authority had expired. The Coast Guard did not maintain an accurate, up-to-date listing of currently warranted contracting officers; and
- Commitments were not routinely monitored for aging or released timely so that funds could be committed and obligated elsewhere. At the time of our testwork, more than one-third of recorded unobligated commitments (approximately 1,200) were over 90 days old, and a substantial portion of those were recorded prior to FY 2004.

3. At EPR, the statement of budgetary resources was misstated through August 31, 2004 because of its method of accounting for investments. EPR recorded an audit adjustment to correct the misstatement as of September 30, 2004.

Cause/Effect: Several of the conditions at ICE resulted from difficulties with the transfer of the accounting operations of S&T,IAIP and other components from legacy agencies to ICE in FY 2004. ICE and legacy agency management did not coordinate the transition process to ensure that all transactions were properly recorded in the general ledgers of S&T, IAIP directorates and other components during the transfer of accounts to ICE. These conditions can also be attributed directly to weaknesses described in Comment B - *Financial Management and Oversight at Immigration and Customs Enforcement.*

Coast Guard chose not to use the system configuration controls to flag commitments and obligations that might be in excess of appropriated amounts. Other system and processing limitations hampered the timely recording of budget authority. Weaknesses in policies and procedures also contributed to the conditions.

Weak controls in budgetary accounting and associated contracting practices increase the risk that DHS and its bureaus could violate the *Anti-Deficiency Act* and overspend their budget authority. The financial statements are also at greater risk of misstatement. The untimely release of commitments may prevent funds from being used timely for other purposes.

Criteria: The *Anti-Deficiency Act* prohibits agencies from obligating or disbursing more than their appropriations and apportionments, has strict requirements for reporting violations, and includes penalties for violations. GAO *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular A-11 *Preparation, Submission, and Execution of the Budget,* requires Federal agencies to submit their apportionment requests on an SF-132 for each appropriation unless permission is granted otherwise. According to JFMIP's *Core Financial System Requirements*, an agency's core financial management system must ensure that an agency does not obligate or disburse funds in excess of those appropriated and/or authorized, and specific system edits and user notifications related to funds control must be in place. The Federal Acquisition Regulation (FAR) Section 1.16 addresses the authorities and responsibilities granted contracting officers. Treasury's USSGL guidance specifies the accounting entries related to investment transactions.

Independent Auditors' Report
Appendix I – Material Weaknesses in Internal Control

Recommendations: We recommend that:

1. ICE:
   a) Perform a review in sufficient detail to determine if ICE, or any component where ICE performs accounting services, has violated the *Anti-Deficiency Act* during FY 2004, and report any violations in accordance with U.S.C. Title 31;
   b) Record the obligations entered into by the legacy agency on S&T's behalf into S&T's general ledger at the transaction level; and implement procedures to ensure that S&T obligations entered into by the legacy agency are recorded timely;
   c) Improve polices and procedures to ensure that contracting officers do not approve purchases that exceed their authority and to require their signature on the original obligating documentation; and
   d) Improve its policies and procedures related to preparation of the SF 132 and SF 133 and periodic, e.g. quarterly, reconciliation of these reports to the general ledger. Reconciliations should be performed at the Treasury Appropriation Fund Symbol (TAFS) level, with differences investigated and properly corrected.
2. Coast Guard:
   a) Activate the electronic edit checks in its budget module and general ledger systems to prevent incurring commitments and obligations in excess of appropriations and apportionments and consider establishing automated controls to prevent processing of procurement transactions by contracting officers who do not have active warrant authority;
   b) Develop procedures and controls related to the review and processing of Treasury warrants prior to recording them into the main general ledger system. Review the appropriation data received from Treasury; and then make appropriate revisions and changes.
   c) Improve controls related to preparation of the SF 132 and SF 133 and periodic, e.g., quarterly, reconciliation of these reports to the general ledger. Reconciliations should be performed at the TAFS level, with differences investigated and properly corrected;
   d) Obtain proper advance written approval from OMB to prepare the SF-132 with combined appropriations. If approved, the Coast Guard should prepare a schedule in the notes to the SF-132 indicating the specific amounts by appropriation, and improve its document retention;
   e) Revise controls and related policies and procedures to:
      - Review and update the warrant authority of active contracting officers more frequently; implement system controls to flag procurement transactions when the officer's warrant is expired; and improve documentation for each officer's warrant history;
      - Periodically review commitments, and determine the feasibility of modifying the budget module to transmit all commitments, regardless of dollar amount, to the general ledger system; and
   f) Develop and provide specific training related to any internal controls and related policy and procedure changes.
3. EPR should correct its method of accounting for investments during the year, related to its National Flood Insurance Program, to follow the recommended method presented in the Treasury's USSGL guidance.

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J. Intragovernmental and Intradepartmental Balances

Background: DHS conducts business with other Federal agencies resulting in intragovernmental receivables, payables, and the reporting of revenues and expenses from intragovernmental transactions. Federal accounting and reporting regulations require Federal agencies to routinely identify and reconcile intragovernmental balances and transactions with trading partners. These procedures help ensure that intragovernmental balances properly eliminate in the government-wide consolidated financial statements. DHS bureaus also conduct business with each other, resulting in the same type of transactions and balances that must be netted against each other to produce accurate consolidated financial statements for DHS.

Conditions: Regarding intragovernmental balances, we noted that ICE, (including S&T, IAIP, BTS Headquarters, Management and CIS – DHS components where ICE functions as accounting services provider), EPR, and Coast Guard have not developed and adopted effective SOPs or established systems to completely track, confirm, and reconcile intra-DHS balances and/or transactions with trading partners, in a timely manner. In addition, DHS did not reconcile its fourth quarter intragovernmental balances with other federal entities. Consequently, the DHS "Material Difference/Status of Disposition Certification Report," submitted to Treasury for September 30, 2004, showed material differences "unknown or unreconciled" or "accounting/reporting errors" in excess of $370 million and $715 million, respectively. These conditions also impacted DHS' ability to accurately report transactions with government trading partners in the consolidated financial statements and in the RSI section of the financial statements, as required.

Regarding intradepartmental balances, we noted that throughout the year DHS was unable to produce accurate consolidated financial statements due, in part, to significant out-of-balance conditions between DHS bureaus. Intra-DHS transactions between ICE, CBP, CIS and other DHS components did not eliminate correctly at the consolidated level during the year. Further, DHS was unable to completely reconcile out-of-balance intradepartmental transactions at year-end, resulting in the need for significant "top-side" adjustments, based primarily on estimates and analytical comparisons, to close the general ledger and prepare consolidated financial statements. Many of these topside adjustments cannot be supported with sufficient documentation that evidences reviews for completeness and accuracy.

Cause/Effect: Financial system limitations at ICE (and for DHS components it services), and the Coast Guard prevented these bureaus from tracking activity with government trading partners and thus, manual processes have been established. Accounting data for DHS components that ICE services, e.g., S&T and IAIP, and provided to ICE did not include detailed supporting schedules of trading partner activity that would have facilitated the reconciliation process. Coast Guard has not fully utilized its accounting system functionality to identify and track intragovernmental balances. EPR did not reconcile intradepartmental accounts timely during the year due to partner code configuration differences between EPR's and DHS's IT systems, that were by corrected by the end of the year. A lack of resources in the OCFO prevented the accountant responsible for intragovermental reconciliations from researching and reconciling intragovernmental differences in a timely manner during the year and at year-end. Reconciling trading partner activity and balances at least quarterly is necessary to identify material out-of-balance conditions between federal entities and to support an accurate consolidation of DHS with the government-wide financial statements. The significant restructuring of DHS that created ICE, CBP, and CIS contributed significantly to the out-of-balance conditions between DHS bureaus.

Criteria: The *Treasury Federal Intragovernmental Transactions Accounting Policies Guide*, dated October 23, 2002, requires quarterly reconciliation of intragovernmental asset, liability and revenue amounts with trading partners. Further, the TFM, Section 4060, *Intragovernmental Activity/Balances*, requires reporting agencies to reconcile and confirm intragovernmental activity and balances quarterly for specific reciprocal groupings. OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, requires the presentation of transactions with trading partners to be presented in RSI. It also requires agency financial statements to be presented on a consolidated basis, including the elimination of significant intradepartmental transactions and balances for reporting purposes.

Recommendation: We recommend that all DHS bureaus and programs, in conjunction with the DHS OCFO, develop and implement procedures to positively confirm and reconcile, at least on a quarterly basis, all intragovernmental activity and balances with their intragovernmental trading partners including other DHS component entities, as prescribed by Treasury guidance. In addition, transactions with trading partners should be completely and accurately presented in the RSI section of the Department's PAR. These procedures also should ensure that all intradepartmental activity and balances are identified and properly eliminated for DHS' consolidated financial statements.

K. Deferred Revenue on Immigration and Naturalization Applications

Background: CIS accepts millions of applications annually and typically collects more than $1 billion in fees from applicants seeking immigration and naturalization services. Applications are received and processed at four service centers, the National Benefits Center, over 30 district offices, and numerous satellite offices. Upon receipt of an application, CIS personnel input the data into a variety of information systems. Numerous ad hoc systems are used to perform monitoring and file tracking functions during the acceptance and adjudication process. To determine the amount of revenue to be deferred at the end of the reporting period, CIS relies on automated application tracking systems, in particular the CLAIMS 3 LAN[8] and CLAIMS 4[9]. A query of these systems is performed to determine the total number of pending applications and the associated fees received for each of these applications. The accuracy of the deferred revenue calculation depends on the reliability of the application status recorded in the systems. Federal accounting standards require that application revenue must be deferred until adjudication is complete, and consequently the status (e.g., completion) of applications has a direct effect on DHS' consolidated financial statements. There are a number of information systems initiatives underway to improve the efficiency of and the quality of management information from the application and adjudication process.

Conditions: We noted the following internal control weaknesses related to the acceptance and adjudication of immigration and naturalization applications at CIS:

- Not all applications were maintained in the primary databases – CLAIMS 3 LAN and CLAIMS 4. Numerous ad hoc systems, including some manual systems, were used to perform monitoring and file tracking functions during the acceptance and adjudication process that were not integrated. Procedures have not been implemented to compare the actual pending applications tracked in the ad-hoc systems with the number being estimated for the deferred revenue, leading to processing and quality assurance inefficiencies;
- CIS lacked SOPs for identifying the accuracy and reliability of CLAIMS 4 data and the query of CLAIMS 4, which provides the number of pending naturalization applications and the associated fee that is used in the deferred revenue calculation;
- Quality assurance procedures, , adopted to verify the accuracy of application status data in CLAIMS 3, were not consistently performed by the service centers and the National Benefits Center. In addition, the information provided to CIS headquarters as a result of the quality assurance procedures was not in sufficient detail to permit analysis of results, support conclusions and develop corrective actions. The lack of such quality assurance procedures in previous years led to bureau-wide end of the year inventories that were disruptive to CIS operations and delayed the completion of year-end financial reporting; and
- Fees collected with immigration applications were not always deposited in accordance with Treasury guidelines.

Cause/Effect: Policy and initiatives to replace ad hoc systems used to track the status of applications and associated fees have been slow in development. The lack of integrated systems and use of ad hoc systems create significant inefficiencies and increase the risk of errors and reporting inconsistencies. The lack of SOPs increases the risk of inconsistency by creating a lack of standardization, and of errors in the data. Due to the concerns over data quality in both the local and national feeder systems, and the reporting

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[8] CLAIMS 3 LAN is the acronym for Computer Linked Application Information Management Systems, Version 3, Local Area Network.
[9] CLAIMS 4 is the acronym for Computer Linked Application Information Management Systems, Version 4.

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process, CIS had to perform an extensive service-wide inventory of pending (SWIP) applications in previous years to accurately state deferred revenue in its financial statements. A SWIP is labor-intensive and time-consuming, but necessary in the absence of adequate quality assurance procedures to verify perpetual application inventory systems and determine adjustments to deferred revenue.

Overall, resources are insufficient to address the volume of applications received, thus preventing the applications from being input into the respective system within one day of receipt. As a result, fees accompanying the applications are also often not deposited within the Treasury required time frame. The contract for data entry and deposit services at the service centers have conflicting performance clauses that provides inconsistent guidance on timing of fee deposits.

Criteria: OMB Circular A-127 requires that financial management systems provide effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems. Because CIS' various application and adjudication systems support preparation of the financial statements, they are considered financial systems. OMB Circular A-123 states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports." SFFAS No. 1, states, "Federal entities may receive advances and prepayments from other entities for goods to be delivered or services to be performed. Before revenues are earned, the current portion of the advances and prepayments should be recorded as other current liabilities. After the revenue is earned (goods or services are delivered, or performance progress is made), the entity should record the appropriate amount as a revenue or financing source and should reduce the liability accordingly."

Section 8030.20 of the TFM stipulates that "agencies will deposit receipts totaling $5,000 or more on the same day received prior to depositary cutoff time" and "monies received too late in the day to meet the deposit cutoff time must be deposited the following business day. Agencies must have adequate internal controls in place to ensure the security of all undeposited funds."

Recommendations: We recommend that CIS:

a) Continue the information systems initiatives underway to improve the efficiency and quality of management information from the application and adjudication process and gradually reduce the number of ad hoc systems in use;

b) Develop and implement policies and procedures to verify the accuracy and reliability of CLAIMS 4 and CLAIMS 3 LAN and the query of CLIAMS 4 and CLAIMS 3 LAN for reporting deferred revenue. CIS personnel should be trained on proper implementation of the SOPs;

c) Require all locations to perform quality assurance counts of pending applications with a frequency (e.g., rotating quarters) that is sufficient to provide reasonable assurance of the completeness and accuracy of data used to compute deferred revenue. The results of the quality assurance counts (e.g., the error rate) should be recorded and used to develop a quality assurance function. Policies governing cycle counts should be developed and followed; and

d) Revise policies and procedures, including contractor agreements, to ensure that fee receipts are deposited in accordance with Treasury guidelines.

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L. Environmental Liabilities

Background: The Coast Guard's environmental liabilities consist of two main types: shore facilities and vessels. Shore facilities include any facilities or property other than ships and aircraft (e.g., buildings, fuel tanks, lighthouses, small arms firing ranges, batteries from aids to navigation, etc.).

The Plum Island Animal Disease Center (PIADC) was transferred to DHS from the Department of Agriculture and is dedicated to the study of animal diseases to better protect the food supply. Previously the PIADC was a U.S. Army installation. The type of research conducted at PIADC and its past use as a military facility are indicators that the land and buildings may require substantial environmental clean-up to eliminate environmental contaminants. PIADC is now part of DHS' S&T Directorate.

Conditions: We noted the following internal control weaknesses related to environmental liabilities:

1. At Coast Guard:

   - Consistent policies or procedures have not been developed for the identification, evaluation, and estimation of potential environmental remediation of Coast Guard sites, thereby resulting in different approaches by shore facility commands and ultimately varying liability estimates;
   - Personnel do not always follow stated policies and procedures, such as current year indexing and usage of contingency factors for possible unknown conditions;
   - Environmental liability estimates associated with lighthouses/light stations did not include future Phase II (soil testing) assessment or remediation costs;
   - The estimates for both shore facilities and vessels were misstated due to ineffective procedures. In addition, we noted that the Coast Guard did not properly index the liability costs to current year dollars, nor did they properly include contingency factors for unknown conditions resulting in a potential understatement of the liability in the financial statements;
   - Consistent policies and procedures have not been developed to estimate the cost of remediation of specific projects, such as lighthouses and small arms firing ranges; and
   - There is no management review of the environmental compliance and remediation estimates reported at year-end to ensure accuracy and consistency in recording the liability in the financial statements.

2. At S&T, policies and procedures have not been developed to determine if an environmental liability exists at the PIADC and if so to accurately estimate and record an environmental liability for the cost of cleanup.

Cause/Effect: Coast Guard has not developed consistent written agency-wide policies to define the technical approach, cost estimation methodology, and overall management of its environmental remediation projects, resulting in inconsistency in its estimates and possible misstatement of the liability in their financial statements.

Criteria: SFFAS No. 6, paragraph 85, defines environmental cleanup costs as those costs for removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated PP&E. Paragraph 88 states that these cleanup costs meet the definition of liability provided in SFFAS No. 5, *Accounting for Liabilities of the Federal Government.* In addition, SFFAS No. 6, paragraph 96, states that remediation estimates shall be revised periodically to account for material changes due to inflation or deflation and changes in regulations, plans and/or technology. New remediation cost estimates should be provided if there is evidence that material changes have occurred; otherwise estimates may be revised through indexing.

Federal Accounting Standards Advisory Board's Technical Release No. 2, *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government*, states that an agency is required to recognize a liability for environmental cleanup costs as a result of past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable. Probable is related to whether a future outflow will be required. Reasonably estimable relates to the ability to reliably quantify in monetary terms the outflow of resources that will be required.

The GAO *Standards* state that management is responsible for developing and documenting detailed policies, procedures, and practices that fit their agency's operations. As part of their monitoring of internal control, management must continue to maintain these policies and procedures and assess the quality of performance over time.

Recommendations: We recommend that

1. Coast Guard:
   a) Implement policies and procedures to ensure the proper calculation and review of cost estimates for consistency and accuracy in financial reporting; and
   b) Develop and implement policies and procedures to apply indexing and contingencies to environmental estimates on a consistent basis, and to require their documentation.
2. S&T evaluate the PIADC facility using a qualified environmental specialist to determine if an environmental liability exists, and if so to accurately estimate and record an environmental liability for the cost of cleanup.

M. Custodial Activity Performed by Customs and Border Protection

Background: CBP, as a component of DHS, has continued to perform an important revenue collection function for the U.S. Treasury. CBP collects approximately $24 billion in import duties, taxes and fees annually on merchandise arriving in the United States from foreign countries. Receipts of import duties and related refunds are presented in the statement of custodial activity in the DHS consolidated financial statements. CBP is the only DHS bureau with significant custodial responsibilities.

Generally, an importer is required to pay CBP the appropriate duties, taxes, and fees at the port of arrival (port of origin). An exception is made, however, for goods transported "in-bond" from the port of origin to another port (port of destination) within the United States. Merchandise traveling in-bond is not subject to duties, taxes, and fees until it reaches the port of destination where it is ultimately released into the commerce or destroyed. The bonded carrier is ultimately obligated by their official bond to ensure the integrity of the merchandise until disposition and the payment of appropriate duty, if any, is due. It is CBP's responsibility to control the movement and disposition of in-bond shipments with effective policies and regulations that result in either collection of applicable duties, taxes, and fees at the port of destination or the export of the merchandise. CBP has developed a compliance measurement program, called TINMAN, to select, review and determine overall compliance of in-bond movements.

Drawback is a remittance in whole or in part, of duties, taxes, or fees previously paid by an importer. Drawback typically occurs when the imported goods on which duties, taxes, or fees have been previously

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paid are subsequently exported from the United States or destroyed prior to entering the commerce of the United States. Depending on the type of claim, the claimant may have up to eight years from the date of importation to file for drawback.

Conditions: We noted the following internal control weaknesses related to in-bond movements of imported goods.

CBP:

- Did not have a reliable process of monitoring the movement of in-bond shipments;
- Lacked adequate written SOPs for the use of TINMAN; and
- Lacked consistent performance of a compliance measurement program to periodically assess the risk and compute an estimate of underpayment of duties, taxes and fees.

We also noted the following internal control weaknesses at CBP related to the drawback of duties, taxes, and fees paid by importers:

- The revenue accounting system, Automated Commercial System (ACS), lacked controls to detect and prevent excessive drawback claims and payments, necessitating inefficient manual processes to compensate. ACS did not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries or export documentation upon which the drawback claim was based. For example, ACS did not contain electronic edit checks that would flag duplicate claims for export of the same merchandise;
- Drawback review policies did not require drawback specialists to review all related drawback claims against the underlying consumption entries to determine whether, in the aggregate, an excessive amount was claimed; and
- At final liquidation of a drawback claim, although ACS flags a drawback in excess of the gross amount paid on an import, ACS does not have a control to prevent a claim from being processed for an erroneous amount.

Cause/Effect: Much of the in-bond and drawback process was manual, placing an added burden on limited resources.

For in-bond, we noted that in most cases in-bond imports were opened correctly in the system at the arrival ports; however, the ports did not have the resources to close out all in-bond movements that were received at the destination port. Policies and procedures have not been developed and/or implemented to reliably and accurately track and close in-bond movements in a timely manner. System limitations reduced the effectiveness of physical inspections and the reliability of in-bond reports and prevented electronic comparisons of entry and export information. Without an adequate process to track and close in-bond movements and an effective compliance measurement program, CPB lacks assurance that: (i) declared quantity and type of cargo moving in-bond is accurate and complete, (ii) cargo actually reaches its scheduled destination, and (iii) calculated and collected revenue for cargo moving in-bond is accurate and complete in relation to the entry summary filing.

For drawback, CBP did use a sampling approach to compare, verify, and match consumption entry and export documentation to drawback claims submitted by importers. However, procedural limitations decreased the effectiveness of this approach. The inherent risk of fraudulent claims or claims made in error is high for the drawback program, and therefore, good internal controls are essential to manage and reduce the risk of erroneous payments.

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Independent Auditors' Report
Appendix II – Other Reportable Conditions in Internal Control

Criteria: Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. Further, while DHS was not subject to FFMIA, OMB's *Revised Implementation Guidance,* states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations. In addition, CBP policies require that all in-bond transactions should be closed out timely to ensure that goods are not diverted into commerce without filing and paying the proper amount of duties, taxes, and fees. JFMIP publications and OMB Circular No. A-127 outlines the requirements for Federal systems. JFMIP's *Core Financial System Requirements,* states that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities. Circular No. A-127 requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Wherever appropriate, data needed by the systems to support financial functions should be entered only once and other parts of the system should be updated through electronic means consistent with the timing requirements of normal business/transaction cycles.

The *Improper Payments Information Act of 2002*, effective in FY 2004, requires agencies to assess the risk of erroneous payments and develop a plan to correct control weaknesses. In addition to the regulatory requirements stated above, CBP's *Drawback Handbook*, dated July 2004, states that management reviews are necessary to maintain a uniform national policy of supervisory review.

Recommendations: We recommend that CBP:

a) Design in-bond monitoring and reconciliation controls into the new systems that will replace ACS in the future;

b) Develop and implement SOPs that define procedures and responsibilities for the TINMAN program;

c) Reinstate the compliance measurement audits over the in-bond program, including a methodology for measurement of results from inspections performed based on TINMAN selection;

d) Implement effective internal controls over drawback claims as part of any new systems initiatives, including the ability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and exportation documentation for which the drawback claim is based, and identify duplicate or excessive drawback claims;

e) Adopt a review methodology to allow a statistical projection from drawback testing; and

f) Revise current policies and procedures to require drawback specialists to review all prior related drawback claims against a designated consumption entry to determine whether, in the aggregate, an excessive amount was claimed against the consumption entries.

Independent Auditors' Report
Appendix III – Compliance and Other Matters

(Findings A – J and K – M are presented in Appendices I and II, respectively)

N. *Federal Managers' Financial Integrity Act of 1982*

OMB Circular A-123 requires agencies and Federal managers to (i) develop and implement management controls; (ii) assess the adequacy of management controls; (iii) identify needed improvements; (iv) take corresponding corrective action; and (v) report annually on management controls (commonly known as management's FMFIA report). We noted that DHS management's FMFIA report did not contain corrective action plans for all material weaknesses identified in its PAR. DHS and its components – CIS, Coast Guard, EPR, ICE, TSA and DHS – have not established effective systems, processes, policies and procedures to evaluate and report on internal accounting and administrative controls, and conformance of accounting systems to properly and accurately report on compliance with Sections FMFIA Sections 2 and 4.

Recommendations: We recommend that DHS improve its process to ensure compliance with FMFIA in FY 2005.

O. *Federal Information Security Management Act (Electronic Government Act of 2002)*

DHS is required to comply with the FISMA, which was enacted as part of the *Electronic Government Act of 2002*. FISMA requires agencies and departments to: 1) provide information security for the systems that support the operations under their control; 2) develop, document and implement an organization-wide information security program; 3) develop and maintain information security policies, procedures and control techniques; 4) provide security training and oversee personnel with significant responsibilities for information security; 5) assist senior officials concerning their security responsibilities; and 6) ensure the organization has sufficient trained personnel to comply with FISMA requirements. We noted instances of non-compliance with FISMA that have been reported by us in Appendix I within Comment D– *Financial Systems Functionality and Technology*.

Recommendations: We recommend that DHS follow the recommendations provided in Appendix I, Comment D.

P. *Single Audit Act Amendments of 1996,* Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up,* as revised, and the *Robert T. Stafford Disaster Relief and Emergency Assistance Act* as amended October 2000 (Stafford Act)

As grant-making agencies, EPR, SLGCP and TSA are required to comply with certain provisions of OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations, Subpart D – Federal Agencies and Pass-Through Entities*, and OMB Circular No. A-50, *Audit Follow-up*. The circulars require agencies awarding grants to ensure they receive grantee reports timely, to follow-up on grantee single audit findings, and to communicate program identification information to the grantees. In addition, under the Stafford Act, EPR must perform cost-share analysis of applicable grants to ensure that the grantees are funding their appropriate share of program costs.

Although certain procedures have been implemented to monitor grantees and their audit findings, we noted that EPR, SLGCP and TSA did not have procedures in place to fully comply with provisions in OMB Circulars No. A-133 and A-50 that require them to timely obtain and review grantee single audit reports and follow up on questioned costs and other matters identified in these reports. Since single audits typically are performed by other entities outside of DHS, procedures related to these reports are not

III.1 (Continued)

always entirely within EPR's, SLGCP's and TSA's control. We noted that EPR was not in full compliance with the *Stafford Act* because certain cost-share analysis and follow-up were not timely performed or provided to State grantees in one regional office. In addition, EPR had not always provided notification of the *Catalog of Federal Domestic Assistance* (CFDA) number to grantees.

Recommendations: We recommend that:

1. DHS management develop and implement department-wide polices and procedures to ensure compliance with OMB Circulars A-133 and A-50, including the identification of which bureau must comply. Until policy guidance is received from DHS management, EPR and SLGCP should perform the following in FY 2005:
   a) Develop and implement a tracking system to identify each grantee for which an OMB Circular A-133 single audit is required and the date the audit report is due;
   b) Use the tracking system to ensure audit reports are received timely, or to follow-up when reports are overdue; and
   c) Perform reviews of grantee audit reports, issue related management decisions, and ensure that the grantees take appropriate corrective action, on a timely basis.
2. In addition, EPR should perform the following in FY 2005:
   a) Ensure that grants management specialists review and document the results of their cost-share analyses for reasonableness and accuracy, and perform timely follow-up if their analyses indicate potential issues with the cost-share amounts; and
   b) Ensure that all grant identifying information, including CFDA numbers, is communicated to the grantees timely and that evidence of such communication be maintained in the applicable grant file.
3. TSA should implement policies and procedures to effectively monitor grantee's performance to meet the requirements of OMB A-50, and obtain, review and maintain the appropriate performance reports, i.e., SF-424 and SF-270.

Q. *Improper Payments Information Act of 2002*

DHS is required to comply with the *Improper Payments Information Act of 2002* (the Act). The Act requires agencies to review all programs and activities they administer annually and identify those that may be susceptible to significant erroneous payments. For all programs and activities where the risk of erroneous payments is significant, agencies must estimate the annual amounts of erroneous payments, and report the estimates to the President and Congress with a progress report on actions to reduce them. The agency must report a statistically valid error projection for susceptible programs in its annual PAR. To facilitate the implementation of the Act, OMB issued guidance in Memorandum M-03-13, which among other matters provided a recommended process to meet the disclosure requirements. We noted that DHS did not comply with the Act, as follows:

DHS did not:

- Properly define programs and activities;
- Institute a systematic method of reviewing all programs and identifying those it believed were susceptible to significant erroneous payments; and

- Properly sample or compute the estimated dollar amount of improper payments.

Recommendation: We recommend that DHS follow the guidance provided in OMB M-03-13 in FY 2005, including re-examining the definition of a program, completing the necessary susceptibility assessments, instituting sampling techniques to allow for statistical projection of the results, and providing information for proper disclosure in its PAR.

Summary of Conditions As Reported in 2003 Performance and Accountability Report	FY 2004 Status/ Disposition
A. Financial Management and Personnel	
1 OCFO has not established a hierarchy of financial reporting authority; assessed critical process needs necessary to install proper internal controls over financial reporting; developed standard operating procedures over financial reporting; or hired or contracted sufficient qualified personnel to properly perform the financial reporting function.	**Repeated as Material Weakness** (Comments A and C)
2. The Coast Guard and SNS have weaknesses in financial management oversight over the financial reporting process.	**Partially Repeated as Material Weakness** (Comment C)
B. Financial Reporting	
1. OCFO and the DHS bureaus have not prepared timely consolidated financial statements; implemented electronic interfaces between bureaus and OCFO for reporting; compared TIER and CFO Vision to Treasury USSGL roll-ups and financial statement crosswalks; reviewed bureau reports for consistent use of the USSGL; prepared financial reporting instructions related to TIER and to all elements of the PAR; prepared RSSI correctly; adopted an effective process to compile year-end consolidated financial statements; identified laws and regulations that may have a direct and material effect on the financial statements; or implemented procedures to ensure accuracy and completeness of FMFIA.	**Partially Repeated as Material Weakness** (Comment C)
2. Coast Guard has a reporting process that is complex and requires a significant number of on-top entries, and lacks documentation of internal controls.	**Repeated as Material Weakness** (Comment C)
3. CIS, ICE, EPR, and Coast Guard do not have documented policies and procedures for exporting data from the general ledger for the TIER submission routinely; quality control procedures over financial reports are not regularly performed; TIER input is not reconciled to outputs provided by the OCFO; and the accuracy of financial information is highly dependent on the knowledge of a few individuals.	**Partially Repeated as Material Weakness** (Comment C)

C. Financial Systems Functionality and Technology	
1. OCFO and DHS bureaus have IT and financial system control and functionality weaknesses in entity-wide security program planning and management, access controls, application software development and change controls, system software, segregation of duties, and service continuity.	**Partially Repeated as Material Weakness** (Comment D)
D. Property, Plant, and Equipment	
1. Coast Guard has not maintained cost documentation for some PP&E; accounted properly for depreciation of improvements made for some PP&E; established policies related to the useful lives of certain vessels; and properly classified repairable items as PP&E.	**Partially Repeated as Material Weakness** (Comment F)
2. TSA lacks a property management system that interfaces and reconciles with the general ledger and does not have adequate polices and procedures for the reporting of acquisitions and disposals of property	**Corrected**
3. CIS/ICE has not consistently applied procedures to identify and capitalize software development costs or properly reclassify software placed into production.	**Repeated as Material Weakness** (Comment F)
E. Operating Materials and Supplies	
1. Coast Guard procedures and internal controls over physical counts were not operating effectively; OM&S was not always properly tagged; on-hand quantities frequently did not agree to the perpetual inventory records; and the policies were not updated to ensure correct financial reporting.	**Repeated as Material Weakness** (Comment G)
F. Actuarial Liabilities	
1. Secret Service did not record the actuarial pension liability for employees who elected to participate in the D.C. Pension Plan.	**Corrected**
2. Coast Guard did not determine or record the amounts and timing of future payments related to certain entitlements consistent with Federal accounting standards.	**Removed** (Not Significant to Consolidated Financial Statements)

Finding	Status
G. Transfers of Funds, Assets, and Liabilities to DHS	
1. OCFO and DHS bureaus lack procedures to verify accuracy and completeness of March 1, 2003 transferred balances; lack controls to verify the accuracy of monthly financial reports received from legacy agencies; some Memorandums of Understanding (MOU) did not specify the reimbursement terms for services provided; and after the transfer date, some agencies operating under an MOU with DHS had difficulty providing required financial statement information needed for DHS to produce its operating statements for the seven months ended September 30, 2003.	**Partially Repeated as Material Weakness** (Comment B – related to transfers of legacy agency records to ICE)
Reportable Conditions:	
H. Drawback Claims on Duties, Taxes, and Fees	
1. CBP lacks an automated system to track and compare drawback claims to detect and prevent excessive or erroneous drawback amounts; lacks a single integrated system; and policies and procedures for reviewing claims and supervisory review need to be improved.	**Repeated as Reportable Condition** (Comment M)
I. In-Bond Movements of Imported Goods	
1. CBP does not have a reliable process to monitor in-bond movement and also did not utilize its existing in-bond movement compliance measurement process to assess risk and compute an estimate of underpayment of duties, taxes and fees.	**Repeated as Reportable Condition** (Comment M)
J. Acceptance and Adjudication of Immigration and Naturalization Applications	
1. CIS lacks SOPs for tracking and reporting the status of immigration and naturalization applications; related system interfaces; and policies that require periodic cycle counts of its pending applications to verify the accuracy of deferred revenue.	**Repeated as Reportable Condition** (Comment K)
K. Fund Balance with Treasury (FBWT)	
1. Coast Guard did not perform timely reconciliation procedures for FBWT, and lacks SOPs on FBWT reconciliation procedures.	**Repeated as Material Weakness** (Comment E)

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

L. Intragovernmental Balances	
1. Coast Guard, EPR, CBP, Secret Service, CIS/ICE, and certain programs that are accounted for by legacy agencies do not have effective SOPs to track, confirm, or reconcile intragovernmental balances and transactions with trading partners.	**Partially Repeated as Material Weakness** (Comment J)
M. Strategic National Stockpile	
1. SNS has fragmented accounting processes; inventory balances that were not properly valued at historical cost; IT system limitations; and lack of policies and procedures over essential accounting processes.	**Removed** (SNS was transferred to HHS in August 2004)
N. Accounts Payable and Undelivered Orders (UDO)	
1. CIS/ICE had errors in the source data used to calculate accounts payable, and field personnel did not always review UDOs.	**Repeated as Material Weakness** (Comment H)
2. TSA policies and procedures were not in place to accurately compute and accrue accounts payable transactions, and TSA did not have a reliable method to estimate accounts payable.	**Corrected**
3. Coast Guard had difficulty recording accurate UDO and accounts payable balances at year-end and during the year.	**Repeated as Material Weakness** (Comment H)

IV.4